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IN THE

Supreme Court of the United States

OCTOBER TERM, 1995

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.,
Petitioner,

v.

AMERICAN MEDICAL INTERNATIONAL, INC.,
Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Does a federal court, exercising diversity jurisdiction, exceed its authority under *Erie R. Co.* v. *Tompkins*, 304 U.S. 64 (1938), when it creates a new state law cause of action not previously recognized by the courts or authorized by the legislature of the State?

2. Should this Court grant the petition, vacate the judgment below, and remand for further consideration in light of an intervening decision from the state supreme court confirming that state law does not recognize the new cause of action created by the federal court?

PARTIES TO THE PROCEEDINGS AND RULE 29.1 STATEMENT

All parties are listed in the caption. Petitioner is wholly-owned by American International Group, Inc., and has one non-wholly-owned subsidiary, JI Accident & Fire Insurance Co. Ltd. (Japan).

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PETITION FOR A WRIT OF CERTIORARI

National Union Fire Insurance Company of Pittsburgh, Pa. ("National Union") petitions this Court for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in this case on May 17, 1995. This case presents an important and recurring question that has divided the federal circuits: whether a federal court sitting in diversity has the authority to make new state law.

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit is unreported and is reprinted in the appendix hereto ("App.") at 1a. The judgment on special jury verdict entered by the United States District Court for the

Central District of California is unreported and is reprinted at App. 12a.

JURISDICTION

The Ninth Circuit entered judgment in this case on May 17, 1995, App. 1a, and denied National Union's timely petition for rehearing on July 13, 1995. App. 16a. The jurisdiction of the District Court was based on diversity of citizenship. 28 U.S.C. § 1332(a)(1). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Article III, section 2 of the United States Constitution provides, in pertinent part: "The judicial Power shall extend to all Cases, in Law and Equity, * * * between citizens of different States * * *." The Tenth Amendment to the United States Constitution provides: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

Section 1332(a)(1) of Title 28, United States Code, provides: "The district courts shall have original jurisdiction of all civil actions where the matter in controversy exceeds the sum of $50,000, exclusive of interest and costs, and is between—citizens of different States * * *." The Rules of Decision Act, Section 1652 of Title 28, United States Code, provides: "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

STATEMENT OF THE CASE

This case arises out of a charge by respondent American Medical International, Inc. ("AMI") that petitioner National Union breached an insurance contract and the implied covenant of good faith and fair dealing. In a

context in which it was obliged to apply California law, the Ninth Circuit created a new cause of action—not previously recognized by the California courts—by holding that AMI could recover for breach of the implied covenant regardless of whether National Union had valid defenses to coverage under the policy. In so holding, the Ninth Circuit joined one side of a split of authority in the Courts of Appeals concerning a federal court's ability, under principles first enunciated in *Erie R. Co.* v. *Tompkins*, 304 U.S. 64 (1938), to create a new state law cause of action not previously recognized by the courts or authorized by the legislature of the State whose law the federal court is to apply.

National Union issued an insurance policy that covered AMI's directors and officers for claims arising out of wrongful acts committed in the course of their duties. This directors and officers ("D&O") insurance policy also covered AMI in the event it indemnified an officer or director for a covered claim, but did not cover AMI's own corporate liability. The $5 million limit of the National Union policy was excess of the $10 million limit of AMI's primary D&O policy, issued by Harbor Insurance Company ("Harbor"). The National Union policy specifically excluded claims arising out of acts taken to prevent the acquisition of the corporation and claims by former directors.

In 1988, several competing bidders offered to buy AMI. One of the bidders was Lee Pearce, a member of the AMI board of directors. In response to these offers, the AMI board formed a special committee, chaired by director Harold Williams, to review the competing bids. The committee selected a bid by a group headed by First Boston Bank and the Pritzker Interest Group. Pearce then sold his stock in AMI and resigned from the board of directors.

Several of AMI's shareholders and bondholders brought class action lawsuits against the company and its current and former directors, including Williams and Pearce. The suits alleged that the defendants had breached their fiduci-

ary duty by accepting the First Boston/Pritzker bid. Pearce cross-claimed against Williams and AMI, alleging that Williams had rigged the bids against Pearce out of personal animosity, and that the board had improperly rejected his bid.

AMI subsequently settled the shareholder suits, in part using money from the Harbor D&O policy. Although Harbor paid less than $8.75 million of its $10 million policy limit, AMI released it from any further obligations under that policy.[1] The trial court dismissed the bondholder suit, leaving only Pearce's claims against AMI and Williams.

Williams' counsel began negotiations to settle Pearce's claims against Williams, and sought authority from National Union to use its policy limits. Although National Union contended that the Harbor policy limits were not exhausted and that Pearce's claims against Williams were not covered under the terms of its D&O policy, it nonetheless proposed to fund a cash settlement of Pearce's claims against Williams while reserving its right to seek reimbursement if a court subsequently decided that there was no coverage. Williams' counsel rejected this proposal. During the period of these negotiations, AMI refused to indemnify Williams for any separate settlement of the claims against him; AMI would not pay any money to Pearce unless he dismissed his claims against both Williams and AMI.

Approximately three weeks into the trial, National Union, acting with the consent of Williams' counsel and over the objection of AMI, reached an agreement under

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[1] The Ninth Circuit's opinion notes that "AMI advised [National Union] that Harbor had authorized payment of its $10 million policy limit to settle the shareholder actions." App. 3a. While it is true that AMI did so advise National Union, there is no dispute that Harbor did not in fact pay out the $10 million policy limit. Instead, it agreed to pay $8.75 million, and AMI agreed that the policy limits were "deemed exhausted" by this payment.

which Pearce agreed to dismiss his action against Williams with prejudice. In return, National Union agreed to pay Pearce an amount equal to the National Union policy limit, less defense costs, in the event that Pearce did not recover at least that amount from AMI. Under this agreement, the amount guaranteed by National Union was to be reduced, dollar for dollar, by the amount Pearce recovered from AMI. The agreement also required National Union's consent if Pearce sought to settle with AMI for less than $4 million.

Pearce's case against AMI went to the jury. Two weeks into jury deliberations, AMI settled with Pearce for $16 million. AMI subsequently filed this diversity action against National Union in the United States District Court for the Central District of California. AMI claimed, *inter alia*, that National Union had breached the implied covenant of good faith and fair dealing by settling the action against Williams over its objections. A jury found that National Union had breached the good faith covenant, and that this breach had resulted in damages to AMI of $11 million. In addition, the jury awarded AMI $1 million in attorney's fees. The District Court entered judgment accordingly, App. 12a, and National Union appealed.

The Ninth Circuit affirmed. National Union argued that it owed AMI no duty of good faith related to the insurance contract, because it owed no policy benefits to either Williams or AMI for three independent reasons: (a) the $10 million limit of the underlying Harbor policy was not exhausted; (b) the National Union D&O policy expressly excluded claims arising out of acts to prevent the acquisition of the corporation and claims by former directors; and (c) the policy entitled AMI to benefits only if AMI indemnified Williams for his liability, which AMI had refused to do. The Ninth Circuit rejected this argument, holding that National Union could be liable even if it had valid coverage defenses. According to the Ninth Circuit, under California law, the jury could

find that National Union breached its duty of good faith to AMI even though the insurance contract between National Union and AMI provided no coverage to AMI for either the claims against Williams or the claims against AMI. App. 5a-7a, 10a.

The Ninth Circuit purported to derive this rule from a single California Court of Appeal decision indicating, in dictum, that there "may be circumstances" in which such liability would be proper. App. 6a n.4 (citing *McMillin Scripps North Partnership* v. *Royal Ins. Co.*, 19 Cal. App. 4th 1215, 1222, 23 Cal. Rptr. 2d 243, 247 (1993)). In fact, the court in *McMillin Scripps* applied the well-settled rule in California that "a bad faith claim cannot be maintained unless policy benefits are due." 19 Cal. App. 4th at 1222 (quoting *Love* v. *Fire Ins. Exchange*, 221 Cal. App. 3d 1136, 1153, 271 Cal. Rptr. 246, 256 (1990)). The Ninth Circuit also drew support for its new California rule from *Matison* v. *Transamerica Title Ins. Co.*, 845 F.2d 867 (9th Cir. 1988), a decision applying *Arizona* law. App. 5a-6a. Thus, the Ninth Circuit's holding in this case involves not the application of settled state law, but the creation of an entirely new cause of action not previously recognized in California.

The Ninth Circuit denied National Union's timely petition for rehearing on July 13, 1995. App. 16a. On August 4, 1995, however, the Ninth Circuit granted a 60-day stay of mandate pending the filing and disposition of this petition for a writ of certiorari. *Id.* at 17a.

REASONS FOR GRANTING THE WRIT

The Ninth Circuit's decision in this case implicates a split among the circuits on an issue that federal courts face regularly: whether a court exercising diversity jurisdiction has the authority to make new state law. The rule in the Ninth Circuit, epitomized by the present decision, is that a federal court may create new state law by adopting a theory of recovery not previously recognized—

and indeed rejected—in decisions of the relevant state courts. The First, Third, Fourth, Fifth, Seventh, Eleventh, and District of Columbia Circuits expressly refuse to create new state law under such circumstances, while the Second, Sixth, and Eighth Circuits have aligned themselves with the Ninth Circuit on this issue. This conflict has been expressly recognized by the courts themselves. As the Ninth Circuit has explained: "[T]he rule in other circuits is that the federal courts have limited discretion in a diversity case 'to adopt untested legal theories brought under the rubric of state law.' * * * For better or for worse, this circuit has not seen fit to assume such a posture of restraint when it comes to deciding novel questions of state law." *Torres* v. *Goodyear Tire & Rubber Co.*, 867 F.2d 1234, 1238 n.1 (9th Cir. 1989) (citations omitted).

The Ninth Circuit rule—the rule in the Second, Sixth, and Eighth Circuits as well—is inconsistent with the principles this Court enunciated in *Erie R. Co.* v. *Tompkins*, 304 U.S. 64 (1938). In our federal system, the authority to create new rights and obligations arising under state law is limited to the lawmaking organs of the sovereign States—as the First, Third, Fourth, Fifth, Seventh, Eleventh, and District of Columbia Circuits recognize—and is not assigned to the federal courts sitting in diversity. This Court should grant review in this case and resolve the division of authority among the circuits by reversing the judgment of the Ninth Circuit.

I. THE COURTS OF APPEALS ARE DIVIDED ON THE IMPORTANT AND RECURRING QUESTION WHETHER FEDERAL COURTS CAN MAKE NEW STATE LAW

Federal courts sitting in diversity must apply state substantive law. *Erie*, 304 U.S. at 78. When there is no state law authority directly on point, a federal court must make the "*Erie* guess," predicting how the state supreme court would apply established state law to a new situa-

tion. This sort of interstitial decision making is a normal part of the application of any body of law: courts must fill in the gaps based on settled principles when there has been no prior decision addressing the precise issue before the court.

The question this petition presents arises when a federal diversity court is asked not simply to apply settled state law to situations not previously considered by the state courts, but to make new state law. The question in such cases is whether a federal court may expand, modify, or revoke settled state law principles, as a state supreme court might do. This question, which implicates fundamental issues about the proper role of the federal courts, has given rise to conflicting answers in the courts of appeals.

The rule in at least seven circuits is that a federal court sitting in diversity may not go so far as to make new state law. These courts hold that such arrogation of state lawmaking authority is inconsistent with principles of federal-state comity and the proper role of the federal courts enunciated in *Erie*. The Fifth Circuit, for example, has explained that "[t]his court is *Erie*-bound to apply state law as it currently exists, and may not change that law or adopt innovative theories of recovery." *Solomon* v. *Walgreen Co.*, 975 F.2d 1086, 1089 (5th Cir. 1992). *See, e.g., Rubinstein* v. *Collins*, 20 F.3d 160, 172 (5th Cir. 1994) ("It is axiomatic, of course, that we will not expand state law beyond its presently existing boundaries"); *Jackson* v. *Johns-Manville Sales Corp.*, 781 F.2d 394, 397 (5th Cir.) (en banc) (the power "to make the *Erie*-guess * * * does not enable us to alter existing law or to change direction"), *cert. denied*, 478 U.S. 1022 (1986); *United Parcel Service* v. *Weben Indus., Inc.*, 794 F.2d 1005, 1008 (5th Cir. 1986) ("Our *Erie*-role is to apply existing Georgia law, not to adopt innovative theories for the state").

The First Circuit has similarly cautioned that the job of a federal court sitting in diversity is to apply state law, not to make it:

> Absent some authoritative signal from the legislature or the [state courts], we see no basis for even considering the pros and cons of innovative theories * * *. We must apply the law of the forum as we infer it presently to be, not as it might come to be. [*Dayton* v. *Peck, Stow & Wilcox Co.*, 739 F.2d 690, 694 (1st Cir. 1984)].

The First Circuit has repeatedly declined the invitation of diversity plaintiffs to expand existing state law, admonishing that "[w]e have warned, time and again, that litigants who reject a state forum in order to bring suit in federal court under diversity jurisdiction cannot expect that new [state-law] trails will be blazed." *Carlton* v. *Worcester Ins. Co.*, 923 F.2d 1, 3 (1st Cir. 1991) (quoting *Ryan* v. *Royal Ins. Co.*, 916 F.2d 731, 744 (1st Cir. 1990)). *See, e.g., Martel* v. *Stafford*, 992 F.2d 1244, 1247 (1st Cir. 1993) (plaintiff who "selects a federal forum in preference to an available state forum may not expect the federal court to steer state law into unprecedented configurations"); *Porter* v. *Nutter*, 913 F.2d 37, 41 (1st Cir. 1990) (court applying state law in diversity "unwilling to stretch state precedents to reach new frontiers").

As the Third Circuit has explained, important federalism concerns underlie this rule:

> In a diversity case * * * federal courts may not engage in judicial activism. Federalism concerns require that we permit state courts to decide whether and to what extent they will expand state common law * * *. Our role is to apply the current law of the appropriate jurisdiction, and leave it undisturbed. [*City of Philadelphia* v. *Lead Industries Ass'n*, 994 F.2d 112, 123 (3d Cir. 1993) (citations omitted)].

As Judge Aldisert noted in declining an invitation to create new state law in diversity, "[i]f a change in the basic Pennsylvania tort law is to be forthcoming it should emerge from a majority of [the Pennsylvania supreme]

court and not from the Court of Appeals for the Third Circuit." *Vargus* v. *Pitman Mfg. Co.*, 675 F.2d 73, 76 (3d Cir. 1982).

The Fourth, Seventh, and Eleventh Circuits are in accord. *See, e.g., Burris Chemical, Inc.* v. *USX Corp.*, 10 F.3d 243, 247 (4th Cir. 1993) ("Under *Erie Railroad* v. *Tompkins*, the federal courts sitting in diversity rule upon state law as it exists and do not surmise or suggest its expansion.") (citing several recent Fourth Circuit diversity cases declining to recognize new causes of action not theretofore recognized under state law); *A&E Supply Co.* v. *Nationwide Mutual Fire Ins. Co.*, 798 F.2d 669, 678 (4th Cir. 1986) ("Virginia, through its courts and legislature, is the one to restructure its insurance industry, not the federal courts through * * * creation of venturesome torts at common law"), *cert. denied*, 479 U.S. 1091 (1987); *Shaw* v. *Republic Drill Corp.*, 810 F.2d 149, 150 (7th Cir. 1987) (per curiam) (stressing "unwillingness to speculate on any trends in state law" and noting that "our policy will continue to be one that requires plaintiffs desirous of succeeding on novel state law claims to present those claims initially in state court"); *Anderson* v. *Marathon Petroleum Co.*, 801 F.2d 936, 942 (7th Cir. 1986) (Posner, J.) ("federal court is not the place to press innovative theories of state law"); *Afram Export Corp.* v. *Metallurgiki Halyps, S.A.*, 772 F.2d 1358, 1370 (7th Cir. 1985); *Reynolds* v. *Bridgestone/Firestone, Inc.*, 989 F.2d 465, 472 (11th Cir. 1993) ("Had the plaintiff wanted to argue for a change in well-settled state law, the case should have been filed in an Alabama court. We will not extend state law * * *.").

Perhaps the most complete discussion of the rule National Union advocates, and its rationale, is found in the District of Columbia Circuit's opinion in *Tidler* v. *Eli Lilly & Co.*, 851 F.2d 418 (D.C. Cir. 1988). In that case, diversity plaintiffs attempted unsuccessfully to persuade the federal district court that they could recover

under a battery of novel legal theories that had not been recognized by the relevant state courts. On appeal, the plaintiffs renewed their plea. Judge D.H. Ginsburg, writing for himself, then-Judge Ruth Bader Ginsburg, and Judge Buckley, explained that it is beyond the role of the federal courts to act as state-law innovators, particularly when the plaintiffs had the choice (as did AMI in this case) of bringing their claims in state court in the first instance:

> Judicial pioneers must no doubt make bold forays into *terra incognita* in order to chart the way to justice, but that is not the office of a federal court exercising diversity jurisdiction.
>
> * * *
>
> The plaintiffs in this case * * * are in a particularly poor position to urge such novelty upon a federal court, which by reason of diversity between the parties, exercises only a derivative jurisdiction. The plaintiffs had a choice of where to litigate their claims—in the appropriate state courts or in a federal court. If the relevant state authorities do not indicate any particular receptiveness to innovative theories upon which the plaintiffs' claims vitally depend, plaintiffs' recourse is not to proceed directly to federal court, there to urge the tribunal to adopt such theories because the equities of the case or fundamental notions of justice require that they recover. * * * It is decidedly not the business of the federal courts to alter or augment state law to meet the felt necessities of the case; to suggest otherwise is to ignore fundamental principles of comity inherent in our federal system of government. [*Id.* at 424, 425.]

In this case, AMI, which suffered considerable pecuniary losses unrelated to its D&O insurance contract with National Union, voluntarily brought its claims against National Union in federal district court. In affirming a judgment in favor of the plaintiff, the Ninth Circuit recog-

nized a new duty arising out of the insurance contract that it believed suited the same "notions of justice" the District of Columbia Circuit rejected as a basis for federal court lawmaking in *Tidler*. In the District of Columbia Circuit, and in at least six other Courts of Appeals, AMI's bad faith claim would not have been seriously entertained, much less sustained.

AMI prevailed on its novel bad faith theory in this case because federal courts in the Ninth Circuit do not feel constrained to apply current state law. The Ninth Circuit has declared itself an arbiter of state law with lawmaking authority equivalent to that of the state courts. *Paul* v. *Watchtower Bible & Tract Society of New York*, 819 F.2d 875, 879 (9th Cir.), *cert. denied*, 484 U.S. 926 (1987). In *Torres* v. *Goodyear Tire & Rubber Co.*, 867 F.2d 1234 (9th Cir. 1989), the Ninth Circuit expressly recognized the sharp inter-circuit conflict on this issue:

> We note that the rule in other circuits is that the federal courts have limited discretion in a diversity case "to adopt untested legal theories brought under the rubric of state law." *Affiliated FM Ins. Co.*, 831 F.2d at 155 (7th Cir. 1987). *See also Erie Railroad Co.* v. *Tompkins*, 304 U.S. 64 (1938); *Dayton* v. *Peck, Stow and Wilcox Co.*, 739 F.2d 690, 694-95 (1st Cir. 1984); *Rhynes* v. *Branick Mfg. Corp.*, 629 F.2d 409, 410 (5th Cir. Unit A 1980). The unwillingness of these courts to speculate on any trends in state law "applies with special force to a plaintiff in a diversity case who has chosen to litigate his state law claim in federal court." *Shaw* v. *Republic Drill Corp.*, 810 F.2d 149, 150 (7th Cir. 1987); *see Afram Export Corp.* v. *Metallurgiki Halyps, S.A.*, 772 F.2d 1358, 1370 (7th Cir. 1985). For better or for worse, this circuit has not seen fit to assume such a posture of restraint when it comes to deciding novel questions of state law. *See Paul* v. *Watchtower*

Bible & Trust Society, 819 F.2d 875, 879 (9th Cir. 1987). [867 F.2d at 1238 n.1.[2]]

The Ninth Circuit in this case, declining to adopt the "posture of restraint" accepted by at least seven other circuits, created a new cause of action previously rejected in California.

Aligned with the Ninth Circuit, courts in the Second, Sixth, and Eighth Circuits have embraced the notion that federal courts sitting in diversity may adopt a novel theory of recovery not recognized by the relevant state courts. According to the Second Circuit, a federal court sitting in diversity is free to consider "all of the resources that the [state's highest court] could use" in making the state law determination, including the State's "policies" and the law of other jurisdictions. *DeWeerth* v. *Baldinger*, 836 F.2d 103, 108 (2d Cir. 1987), *cert. denied*, 486 U.S. 1056 (1988). This rule is said to allow the federal court to "estimate * * * what the state's highest court would rule to be its law," *Stafford* v. *International Harvester Co.*, 668 F.2d 142, 148 (2d Cir. 1981) (citation omitted), in effect permitting a federal court to act with the full law-creating powers of the state's highest court.

In *Johnson* v. *Honeywell Information Systems, Inc.*, 955 F.2d 409 (6th Cir. 1992), the Sixth Circuit deter-

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[2] The inter-circuit conflict the court acknowledged in *Torres* may be an intra-circuit conflict as well. In *Brooks* v. *Hilton Casinos Inc.*, 959 F.2d 757 (9th Cir.), *cert. denied*, 113 S. Ct. 300 (1992), plaintiffs presented a novel Nevada claim of intentional infliction of emotional distress stemming from employment termination. The plaintiffs persuaded the district court that Nevada would recognize the intentional infliction tort in the termination context because the Nevada Supreme Court had recognized it in other contexts. The Ninth Circuit reversed, refusing to recognize plaintiffs' novel theory because the Nevada Supreme Court had given no indication that it would recognize the tort "and the issue is open elsewhere." *Id.* at 766 (Kozinski, J.). The dissenting member of the panel correctly observed that under *Paul* v. *Watchtower*, *supra*, the court was "free to decide what it believes the Nevada Supreme Court would hold." 959 F.2d at 777 (Boochever, J., dissenting).

mined that the Michigan Supreme Court would allow a defense to a claim of wrongful termination of employment based upon employee misconduct discovered after the termination. Without any indication from the Michigan Supreme Court that it would allow such a defense, the Sixth Circuit based its "prediction" on an unpublished Michigan intermediate appellate court decision, on "common sense," and on "the dearth of Michigan case law to the contrary." *Id.* at 413.[3] Such a creative approach would not have been adopted in those federal circuits that expressly eschew "adopt[ing] innovative theories for the state," *United Parcel Service*, 794 F.2d at 1008 (5th Cir.), that will not "even consider[] the pros and cons of innovative theories," *Dayton*, 739 F.2d at 694 (1st Cir.), that decline "to decide whether and to what extent [to] expand state common law," *Lead Industries Ass'n*, 994 F.2d at 123 (3d Cir.), that will not consider "novel state law claims," *Shaw*, 810 F.2d at 150 (7th Cir.), or that decline "bold forays into *terra incognita*" in diversity cases, *Tidler*, 851 F.2d at 424 (D.C. Cir.). The Sixth Circuit—like the Ninth—plainly adheres to a different understanding of its task and powers under *Erie*.

The Eighth Circuit's decision in *Hazen* v. *Pasley*, 768 F.2d 226 (8th Cir. 1985), is a good example of that court's similar willingness to make new state law. A diversity plaintiff alleged a right of action arising out of the asserted "wrongful dominion" over his property by Missouri law enforcement officers. In the admitted absence of any Missouri cases on point, the Eighth Circuit nonetheless concluded that the Missouri Supreme Court

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[3] To cite another example, the appellant in *Woodruff* v. *Tomlin*, 616 F.2d 924 (6th Cir.), *cert. denied*, 449 U.S. 888 (1980), asked the Sixth Circuit to reverse the district court's holding that Tennessee does not recognize a cause of action for attorney malpractice during the course of litigation. The Sixth Circuit did so on nothing more than its conclusion that the intermediate Tennessee appellate decision upon which the district court relied did not require the result the district court reached. *Id.* at 929-930.

would agree with the plaintiff's "public policy" argument and rejected the defendants' contention that any remedy for the wrong alleged by the plaintiff should be addressed by the Missouri legislature. *Id.* at 228-229. The Eighth Circuit justified its conclusion solely on the basis of certain regulatory policies of Missouri law enforcement agencies that appeared consistent with the plaintiff's theory of recovery. *Id.* at 229. The Eighth Circuit thereby converted an internal regulatory policy into an implied right of action—precisely the sort of "judicial activism," *Lead Industries Ass'n*, 994 F.2d at 123 (3d Cir.), "creation of venturesome torts at common law," *A&E Supply Co.*, 798 F.2d at 678 (4th Cir.), and "blaz[ing]" of "new [state-law] trails," *Carlton*, 923 F.2d at 3 (1st Cir.) that the circuits on the other side of the split categorically reject.

The Tenth Circuit appears to be internally split on the question. Some cases suggest that courts in that circuit sitting in diversity may attempt to divine how a state supreme court might rule on a novel theory on the basis of "doctrinal trends indicated by * * * policies" the federal court may glean from state decisions and other sources. *Weiss* v. *United States*, 787 F.2d 518, 525 (10th Cir. 1986). *See also Lutz Farms* v. *Asgrow Seed Co.*, 948 F.2d 638, 641 (10th Cir. 1991). Other cases, however, suggest a greater appreciation of the more limited role a federal court plays in creating new state law under *Erie*. *See, e.g., Taylor* v. *Phelan*, 9 F.3d 882, 887 (10th Cir. 1993) ("As a federal court, we are generally reticent to expand state law without clear guidance from its highest court; but where the expansion directly affects state finances and functions, we should take extra care"); *Mares* v. *Conagra Poultry Co.*, 773 F. Supp. 248, 252 (D. Col. 1991) (Finesilver, J.) ("A federal court sitting in diversity should not anticipate a change in existing state law."), *aff'd*, 971 F.2d 492 (10th Cir. 1992).

The Ninth Circuit's decision in this case is fully consistent with the rule in the Second, Sixth, and Eighth Circuits (and with the rule previously announced in the Ninth Circuit), and directly contravenes the rule in seven other Courts of Appeals. The Ninth Circuit here adopted a novel theory of California law—consistently rejected by California courts—that a good faith obligation exists even in the absence of insurance coverage. The Ninth Circuit purported to find support for this theory in a prior Ninth Circuit decision applying *Arizona* law and in dictum from a single intermediate California court decision, but in no reported case has a California court ever invoked the implied covenant of good faith and fair dealing to create a duty to parties not covered under the insurance policy at issue.[4] Indeed, as explained below, the California Supreme Court has now expressly held that no such duty exists. *See Waller* v. *Truck Insurance Exchange*, No. 5042287, 1995 WL 516406 at *21 (Aug. 28, 1995), discussed at pp. 22-23, *infra*.

California courts use the good faith doctrine as a "*supplement* to the express contractual covenants, to prevent a contracting party from engaging in conduct which (while not technically transgressing the express covenants) frustrates the other party's rights to the benefits of the contract." *Love* v. *Fire Ins. Exchange*, 221 Cal. App. 3d 1136, 1153, 271 Cal. Rptr. 246, 256 (1990). Where a party has no rights to the benefits of the contract, how-

[4] Nor does the Ninth Circuit's prior decision applying Arizona law, upon which the Ninth Circuit relied here, support this rule. In *Matison* v. *Transamerica Title Ins. Co.*, 845 F.2d 867 (9th Cir. 1988), the plaintiffs' insurance contract with Transamerica required Transamerica to defend the plaintiffs in the underlying action; plaintiffs recovered on a tort theory because of Transamerica's bad faith in settling a claim *against the plaintiffs*. *Id.* at 867-868. In the present case, by stark contrast, AMI's insurance contract with National Union did not require National Union to defend AMI in the underlying suit, and AMI recovered on the basis of National Union's settlement of a claim against a third party. *Matison* says nothing about a duty of good faith in the absence of insurance coverage.

ever, "there is no breach of contract and likewise no breach of the insurer's implied covenant." *Id.* at 1152 n.10 (internal citations and quotations omitted). *Accord McMillin Scripps*, 19 Cal. App. 4th at 1222, 23 Cal. Rptr. 2d at 247; *Reagen's Vacuum Truck Serv., Inc.* v. *Beaver Ins. Co.*, 31 Cal. App. 4th 375, 389, 37 Cal. Rptr. 2d 89, 96 (1994) ("A 'bad faith' claim cannot be maintained unless policy benefits are due"); *Tomaselli* v. *Transamerica Ins. Co.*, 25 Cal. App. 4th 1766, 1770 n.4, 31 Cal. Rptr. 2d 224, 226 n.4 (1994) (an insurer's tort obligations "spring from and depend on the existence of the contractual duty to pay"); *Horsemen's Benevolent & Protective Ass'n* v. *Insurance Co. of North America*, 222 Cal. App. 3d 816, 822, 271 Cal. Rptr. 838, 841 (1990) ("The absence of coverage under the INA policy conclusively negates Horsemen's causes of action for bad faith breach of contract as no duty to indemnify or defend existed here.").

In California, "[a]n insurer clearly takes on the duty of protecting, defending, and indemnifying its insured with respect to the scope of coverage that was purchased and attendant duties (defenses and settlement). The insurer does not, however, insure the entire range of an insured's well being, outside of the scope of and unrelated to the insurance policy * * *. It is an insurer, not a guardian angel." *Camelot by the Bay Condominium Owners' Ass'n* v. *Scottsdale Ins. Co.*, 27 Cal. App. 4th 33, 52, 32 Cal. Rptr. 2d 354, 364 (1994).

Here, there was no coverage under the National Union policy for Pearce's claims against either Williams or AMI: the $10 million limits of the underlying Harbor policy were not exhausted and the National Union policy excluded claims arising out of acts taken to prevent the acquisition of the corporation and claims by former directors. Moreover, the policy did not cover AMI's corporate liability, and AMI did not incur any reimbursable expense for indemnifying Williams in the underlying action. In the absence of coverage, National Union did not owe AMI a duty of good faith and fair dealing under California law.

The Ninth Circuit's decision that the existence of these defenses was irrelevant to the maintenance of an action for breach of good faith represents a radical expansion of California law and precisely the sort of "adopt[ion of] innovative theories of recovery," *Solomon*, 975 F.2d at 1089 (5th Cir.), "stretch[ing] state precedents to reach new frontiers," *Porter*, 913 F.2d at 41 (1st Cir.), "specula[tion] on * * * trends in state law," *Shaw*, 810 F.2d at 150 (7th Cir.), and "bold forays into *terra incognita*," *Tidler*, 851 F.2d at 424 (D.C. Cir.), that at least seven other circuits expressly will not undertake. As it turns out, the Ninth Circuit's foray was not only bold, it was wrong. *See* pp. 22-23, *infra*.

II. THE NINTH CIRCUIT'S RULE REGARDING THE ESTABLISHMENT OF NEW STATE LAW IS INCONSISTENT WITH THE PRINCIPLES ESTABLISHED IN *ERIE*

The sharp division among the circuits on the question presented by this petition arises because federal diversity courts often have difficulty delineating the limits of their authority. On one hand, *Erie* established that federal diversity courts are not to go beyond the bounds of state substantive law. This Court declared that Congress has no constitutional authority "to declare substantive rules of common law applicable in a State," and that "no clause in the Constitution purports to confer such a power upon the federal courts." 304 U.S. at 78. Were Congress to enact a statute authorizing federal courts sitting in diversity to make new state law, such a statute would be unconstitutional under the authority of *Erie*.

By the same reasoning, a federal diversity court may not on its own authority alter existing state law:

> A federal court in a diversity case is not free to engraft onto those state rules exceptions or modifications which may commend themselves to the federal court, but which have not commended themselves to the State in which the federal court sits. [*Day &*

> *Zimmerman, Inc.* v. *Challoner*, 423 U.S. 3, 4 (1975) (per curiam)].

A federal court may not "engraft" exceptions or modifications onto state law, and *a fortiori* may not create new substantive state law that has not already "commended" itself to the State. *See Erie*, 304 U.S. at 71 (rejecting the rule that diversity courts are "free to exercise an independent judgment as to what the common law of the State is—or should be"); *United States* v. *Standard Oil Co.*, 332 U.S. 301, 313 (1947) ("in the federal scheme our part * * *, and the part of the other federal courts, outside the constitutional area is *more modest than that of state courts*, particularly in the freedom to create new common-law liabilities, as *Erie R. Co.* v. *Tompkins* itself witnesses") (emphasis added).

On the other hand, federal courts must apply state law in diversity cases even if that law is uncertain. While federal courts may not usurp the authority of state law-making bodies, diversity courts have a duty to predict what a state supreme court would do in cases in which there is no state authority directly on point:

> *Erie R. Co.* v. *Tompkins* did not free the federal courts from the duty of deciding questions of state law in diversity cases. Instead it placed on them a greater responsibility for determining and applying state laws in all cases within their jurisdiction in which federal law does not govern. Accepting the responsibility, as was its duty, this Court has not hesitated to decide questions of state law when necessary for the disposition of a case brought to it for decision, although the highest court of the state had not answered them, the answers were difficult, and the character of the answers which the highest state courts might ultimately give remained uncertain. [*Meredith* v. *City of Winter Haven*, 320 U.S. 228, 237 (1943)].

Unfortunately, the only guidance this Court gave to the lower federal courts in this regard is that issues of state

law are to be decided "with the aid of such light as was afforded by the materials for decision at hand, and in accordance with the applicable principles for determining state law." *Id.* at 238.

Tension between the obligation to apply state law in uncertain cases and the constitutional limitations on federal authority to make state law becomes acute in the all-too-common cases like that at bar, where a diversity court is asked not simply to make the "*Erie* guess," but to expand state law in a manner not contemplated, or perhaps even rejected, by the state courts or legislature. Some courts, like the Ninth Circuit, see their *Erie* obligation as only to "stand in the shoes" of the state courts, and feel free to make new state law. Other courts apply state law, but heed also the federalism and comity concerns that *Erie* and our constitutional system impose. These courts recognize that their role is "more modest than that of state courts," *Standard Oil*, 332 U.S. at 313, and refuse to expand state law. Only this latter rule resolves the tension in a manner consistent with the constitutional limitations that govern the act of a federal court applying state law.[5]

The present case is a good example of the dangers of federal judicial activism in the application of state law. The Ninth Circuit, in applying its own conception of fairness, effectively overruled an accepted and long established rule of California tort law. The Ninth Circuit's

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[5] The difference cannot be dismissed as one of semantics. The innovative state lawmaking engaged in by the Ninth Circuit here or the Eighth Circuit in *Hazen*, for example, would plainly be rejected in the First, Seventh, and District of Columbia Circuits, which specifically admonish plaintiffs who seek recovery under innovative theories of state law to bring those claims to the state courts rather than a federal diversity court. *See, e.g., Martel*, 992 F.2d at 1247; *Shaw*, 810 F.2d at 150; *Tidler*, 851 F.2d at 424-425. As noted, the Ninth Circuit itself recognizes the difference between its refusal to adopt "a posture of restraint when it comes to deciding novel questions of state law" and the more "limited discretion" employed by the other circuits. *Torres*, 867 F.2d at 1238 n.1.

approach to the *Erie* problem allows a court freely to ignore state law and "to alter or augment state law to meet the felt necessities of the case." *Tidler*, 851 F.2d at 425. A court may thus pay lip service to the constitutional restraints of *Erie* while pursuing its own vision of rough justice without regard to the decisions of the State's courts or legislature. And as might be expected to happen when a federal court indulges in such an unguided exercise, it is likely to arrive at the wrong answer—as we now know the Ninth Circuit did here. *See* pp. 22-23, *infra*.

It is neither the business, nor particularly within the expertise, of a federal court to engage in the expansion or modification of state law. When federal courts make incorrect predictions and determinations about state law, they undermine the parties' legitimate expectations, mislead those who rely on such decisions, and impede the orderly development of state law. *See Burford* v. *Sun Oil Co.*, 319 U.S. 315, 327 (1943) ("Delay, misunderstanding of local law, and needless federal conflict with the state policy, are the inevitable product of" federal court intrusion into matters of state law). *See generally* D.K. Sloviter, *A Federal Judge Views Diversity Jurisdiction Through the Lens of Federalism*, 78 Va. L. Rev. 1671, 1676-84 (1992).

The lower federal courts regularly confront the challenge of applying state law to novel claims, and have done so with little guidance from this Court. That these courts are divided on such a fundamental issue as the limitation of their lawmaking authority is intolerable, but perhaps not surprising. This Court's announcement of a general rule in this case would resolve this major split of authority and greatly assist the federal courts in the correctly reasoned disposition of thousands of diversity cases. Federal diversity courts should reject novel claims of state law. Only this bright-line rule, accepted by a majority of the Courts of Appeals, is faithful to the principles of *Erie*.

III. AT A MINIMUM, THIS COURT SHOULD GRANT THE PETITION, VACATE THE JUDGMENT, AND REMAND TO THE NINTH CIRCUIT FOR FURTHER CONSIDERATION IN LIGHT OF AN INTERVENING DECISION OF THE CALIFORNIA SUPREME COURT REJECTING THE CAUSE OF ACTION RECOGNIZED BY THE NINTH CIRCUIT

Shortly after the Ninth Circuit created a new cause of action under California law for breach of the implied covenant of good faith and fair dealing even in the absence of a duty to defend or indemnify, the California Supreme Court specifically rejected the existence of such a cause of action. *Waller* v. *Truck Insurance Exchange*, No. 5042287, 1995 WL 516406 (Aug. 28, 1995).

In *Waller*, an insurer declined coverage of the defendants in a business dispute over corporate control. Those defendants sued the insurer claiming, *inter alia*, that its denial of coverage breached the implied covenant of good faith and fair dealing. After determining that the insurer was under no duty to defend or to indemnify, the California Supreme Court affirmed the holding of the Court of Appeal that there could be no breach of the implied covenant in the absence of obligations under the policy. It adopted the view articulated by the Court of Appeal in *Love* v. *Fire Ins. Exchange*, *supra*, that a "bad faith claim cannot be maintained unless policy benefits are due." *Waller*, 1995 WL 516406 at *1. Because the insurer in *Waller* "was under no obligation to defend or indemnify the [underlying] action, it did not breach the implied covenant of good faith and fair dealing." *Id.* at *22. Thus, the California Supreme Court has now squarely rejected the approach to California law adopted by the Ninth Circuit below.

The *Waller* decision, of course, does nothing to resolve the split in the federal courts discussed above, and therefore does not obviate the need for this Court's plenary consideration of that question. Indeed, the decision only

confirms the risks inherent in the practice of those circuits willing to create causes of action under state law and demonstrates the wisdom of those circuits that follow the contrary approach and exercise restraint when asked to create new state law.

If this Court is not inclined to address that conflict and grant plenary review of the *Erie* issue, however, it should at a minimum grant the petition, vacate the judgment below, and remand for further consideration in light of *Waller*. This Court has frequently followed that practice in cases involving issues of state law when intervening state court decisions appear to have a significant bearing on the validity of the federal court's decision below. *See, e.g., Chew-Villasana* v. *INS*, 113 S. Ct. 313 (1992); *Mullaney* v. *Wilbur*, 414 U.S. 1139 (1974); *Blabon* v. *Nelson*, 393 U.S. 20 (1968); *Collins* v. *Commissioner*, 393 U.S. 215 (1968); *Blaauw* v. *Grand Trunk Western R. Co.*, 380 U.S. 127 (1965); *Conner* v. *Simler*, 367 U.S. 486 (1961); *Downey* v. *Beck*, 343 U.S. 912 (1952); Note, *The Supreme Court, 1960 Term*, 75 Harv. L. Rev. 40, 95-96 (1961) ("Another phase of the Court's remand 'in light of' device is that in which further consideration is directed to a state court decision made subsequent to the lower court's decision. Such cases generally involve diversity actions") (footnotes omitted). *See also Johnson* v. *Union Pacific R. Co.*, 352 U.S. 957 (1957) (per curiam) (granting petition and reversing on authority of intervening state supreme court decision); *Nolan* v. *Transocean Air Lines*, 365 U.S. 293 (1961) (granting, vacating and remanding for reconsideration in light of a state court decision entered after the district court's ruling but not brought to the attention of the court of appeals).

This practice is consistent with basic federalism and comity concerns, because it enables the lower federal court to correct its misunderstanding of state law and

bring that understanding in line with that of the state supreme court, the final arbiter of that law. As the Court observed in *Vandenbark* v. *Owens-Illinois Glass Co.*, 311 U.S. 538, 543 (1941):

> [T]he dominant principal is that *nisi prius* and appellate tribunals alike should conform their orders to the state law as of the time of entry. Intervening and conflicting decisions will thus cause the reversal of judgments which were correct when entered. * * * [U]ntil such time as a case is no longer *sub judice*, the duty rests upon federal courts to apply state law under the Rules of Decision statute in accordance with the then controlling decision of the highest state court. Any other conclusion would but perpetuate the confusion and injustices arising from inconsistent federal and state interpretations of state law.

The leading case—*Huddleston* v. *Dwyer*, 322 U.S. 232 (1944)—is quite similar to this one. In *Huddleston*, the Tenth Circuit construed Oklahoma law in a diversity case. After denial of a petition for rehearing, the Oklahoma Supreme Court issued an opinion contrary to the Tenth Circuit's understanding of Oklahoma law. The Tenth Circuit denied a second petition for rehearing, but this Court granted certiorari, explaining that

> a judgment of a federal court ruled by state law and correctly applying that law as authoritatively declared by the state courts when the judgment was rendered, must be reversed on appellate review if in the meantime the state courts have disapproved of their former rulings and adopted different ones. [*Id.* at 236 (citing *Vandenbark*).]

This Court accordingly vacated the judgment of the Tenth Circuit and remanded the case to that court so that it could reconsider its decision in light of the intervening state supreme court ruling. 322 U.S. at 237-238.

The Court reaffirmed the propriety of this practice more recently in *Exxon Co., U.S.A.* v. *Banque de Paris et des*

Pays-Bas, 488 U.S. 920 (1988). There the Fifth Circuit, in a diversity case, issued a decision turning on a question of Texas law. Thereafter, the Texas Court of Appeals, in a different case, decided the question contrary to the Fifth Circuit's understanding of Texas law. The losing party before the Fifth Circuit petitioned this Court for a writ of certiorari, which this Court granted. After briefing, this Court vacated the Fifth Circuit judgment and remanded for further consideration in light of the intervening state court decision.

Although National Union believes that the Ninth Circuit's decision was wrong as a matter of federal law under the principles enunciated in Parts I and II above, it is now clear at the very least that the decision was also wrong as a matter of state law. The *Vandenbark/Huddleston* obligation to conform a federal diversity decision to current state law extends "until such time as a case is no longer *sub judice*." *Vandenbark*, 311 U.S. at 543. At a minimum, therefore, this Court should grant, vacate, and remand so that the Ninth Circuit may "conform [its] order[] to the state law * * *." *Id.*

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted. In the alternative, the petition should be granted, the judgment vacated, and the case remanded for further consideration in light of the California Supreme Court's decision in *Waller* v. *Truck Insurance Exchange*.

Respectfully submitted,

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APPENDICES

APPENDIX A

[Filed May 17, 1995]

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 93-56382

D.C. No. CV-92-157 ER

AMERICAN MEDICAL INTERNATIONAL, INC.,
Plaintiff-Appellee,

vs.

NATIONAL UNION FIRE INSURANCE COMPANY
OF PITTSBURGH, PA.,
Defendant-Appellant.

Appeal from the United States District Court
for the Central District of California
Edward Rafeedie, District Judge, Presiding

Argued and Submitted March 7, 1995
Pasadena, California

MEMORANDUM *

Before: SCHROEDER and KLEINFELD, Circuit Judges, and KING,** District Judge

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* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by Ninth Circuit Rule 36-3.

** Honorable Samuel P. King, Senior United States District Judge for the District of Hawaii, sitting by designation.

Defendant National Union Fire Insurance Company of Pittsburgh, Pa. ("NU") appeals a $12 million jury verdict for American Medical International, Inc. ("AMI") in AMI's action for breach of an insurance contract and for breach of the implied covenant of good faith and fair dealing. NU contends: (1) that the jury verdict is not supported by substantial evidence and is inconsistent with California law; (2) that the district court erred by refusing to either give the jury NU's proposed coverage instructions or by granting NU judgment as a matter of law on the issue of coverage; (3) that the district court erred by refusing to give the jury NU's proposed instruction on the elements of the tort of bad faith; (4) that the jury's findings that AMI suffered no breach of contract damages but $11 million in bad faith damages are inconsistent and contrary to the district court's instructions; and (5) that the jury's award of $1 million in attorneys' fees was contrary to California law and the district court's instructions. We have jurisdiction pursuant to 28 U.S.C. § 1291 and affirm.

I.

AMI, which owns and operates hospitals and research facilities, in 1988 purchased two insurance policies to reimburse AMI should it have to indemnify its directors and officers for claims made against them in their corporate capacities. The first directors and officers ("D&O") policy was issued by Harbor Insurance Company ("Harbor") and included a policy limit of $10 million. The second policy, with limits of $5 million excess of $10 million, was issued by NU. The NU policy specifically listed AMI as a named insured.

In 1988, several competing bidders offered to buy AMI. The AMI board formed a special committee, chaired by director Harold Williams ("Williams"), to review the competing bids. The committee conducted an "auction," with three competing groups submitting proposals to acquire AMI. One of the unsuccessful bid-

ders was an investment group headed by Lee Pearce ("Pearce"), a member of the AMI board of directors. The winning bidder was a group headed by First Boston Bank and the Pritzker Interest Group.

In March and early April of 1989, five class action lawsuits were filed on behalf of AMI shareholders and one class action was filed on behalf of AMI bondholders against AMI and its then current and former directors, including Williams and Pearce, alleging they had breached their fiduciary duty by accepting the First Boston/Pritzker bid. Pearce cross-complained against Williams and AMI, alleging they had improperly rejected his bid to purchase AMI. AMI notified both Harbor and NU of the litigation, including the Pearce cross-complaint.

In May 1991, AMI advised NU that Harbor had authorized payment of its $10 million policy limit to settle the shareholder actions. AMI asked NU to likewise make its $5 million policy limit available for settlement, but NU refused.[1] Williams' counsel thereafter sought authority from NU to use its policy limit to settle the Pearce claims against Williams, noting that Pearce had offered to settle the claims for $5 million. According to NU, its counsel proposed to fund a cash settlement of Pearce's claims against Williams, while reserving its right to seek reimbursement if a court subsequently held that there was no coverage. According to NU, Williams' counsel refused to consent to a cash settlement if NU reserved its right to seek reimbursement.

About three weeks into the trial of the Pearce action, NU's counsel approached Pearce's counsel and proposed a "guarantee" arrangement, labeled by AMI as a "Mary Carter" agreement.[2] Under the terms of the agreement,

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[1] The shareholder actions were subsequently settled, and the bondholder action was dismissed.

[2] A "Mary Carter" agreement is an arrangement between a plaintiff and a defendant whereby the exposure to liability of the

NU agreed, in exchange for Williams' dismissal from the action, to pay Pearce its $5 million policy limit, less defense costs, in the event Pearce did not recover at least that amount from AMI. The amount guaranteed by NU was to be reduced, dollar for dollar, by the amount Pearce recovered from AMI. Thus if Pearce recovered at least $5 million from AMI, NU would pay nothing. NU included a veto provision in the agreement, pursuant to which Pearce could not settle with AMI for less than $4 million without NU's consent. If Pearce settled with AMI for less than $4 million, he would forfeit the $5 million guarantee.

With Williams out pursuant to the guarantee agreement, AMI was the sole remaining defendant in the Pearce litigation. Two weeks into jury deliberations, AMI settled with Pearce for $16 million. AMI paid the entire amount of the settlement.

II.

NU contends, in effect, that the jury's conclusion that NU breached the covenant of good faith and fair dealing through use of the guarantee agreement is not supported by either substantial evidence or applicable legal precedent.

NU first argues that under the D&O policy it owed no duty to AMI until AMI actually indemnified Williams, because the policy did not insure the corporation for its own liability, but only provided for the reimbursement of amounts paid by the corporation to indemnify an insured director or officer. NU contends that by obtaining Williams' dismissal pursuant to the guarantee agreement, it provided both Williams and AMI with the full protection to which they were entitled under the policy, i.e.,

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settling defendant is limited, "usually in some inverse ratio to the amount of recovery which the plaintiff is able to make against the nonsettling defendant or defendants." Black's Law Dictionary 974 (6th ed. 1990). The term comes from the case of *Booth v. Mary Carter Paint Co.*, 202 So.2d 8 (Fla.App. 1967).

Williams was relieved of the risk of personal liability and AMI was relieved of any risk that it might have to indemnify Williams for his liability to Pearce. AMI, of course, rejects NU's contention that it owed AMI no duty. AMI notes that it was a *named insured* under the D&O policy and paid the policy premiums. As such, AMI argues it was owed a duty of good faith and fair dealing by the insurer, independent of NU's duty to Williams and the other directors.

In support of the jury's conclusion that NU's conduct constituted a breach of the covenant of good faith and fair dealing, AMI notes this court's opinion in *Matison v. Transamerica Title Ins. Co.*, 845 F.2d 867 (9th Cir. 1988). In *Matison*, the insured under a title insurance policy was sued in a quiet title action involving both covered and noncovered claims, the latter alleging fraud and a breach of fiduciary duty. The insurer settled the covered claims with the plaintiff for $80,000, on the condition, however, that the plaintiff vigorously pursue the remaining noncovered claims and not settle them for less than $80,000. Any monies collected by the plaintiff from the insured would reduce the amount payable by the insurer. If the plaintiff recovered $80,000 or more from the insured, the insurer would pay nothing.

The insured sued the insurer for breach of contract and bad faith, and the district court entered judgment for the insurer, holding that the insurer had discharged its duty to defend title to the property by settling the quiet title action. The district court further found that the insurer's partial settlement "did not impair any duty under its contract with the insured." This court, applying Arizona law, disagreed, concluding that the insurer "had a duty of 'a fiduciary nature' not to benefit at the expense of its insured." *Id.* at 868 (citing *Rawlings v. Apodaca*, 726 P.2d 565, 571 (Ariz. 1986)[3]). This court noted

[3] The insurer in *Rawlings* concealed the results of a fire investigation from its insured, who had received the $10,000 policy limit

that such a duty could be breached even where an insurer had performed all of its express contractual undertakings.[4]

NU contends that *Matison* is inapplicable to the instant case because it did not involve a D&O policy, which insures the liability of a corporation's directors and officers —not the corporation itself. NU argues that because it had no personal exposure in the underlying action, it did not advance its own interests at the expense of its insured, i.e., Williams. Additionally, NU notes that it obtained a dismissal of *all* the claims against its insured, both covered and uncovered.

NU's argument ignores the fact that AMI was also its insured. The fact that AMI might be entitled to the policy proceeds only if it were forced to indemnify Williams would not relieve NU of its duty not to benefit at the expense of AMI. NU's guarantee agreement with Pearce had essentially the same effect as Transamerica's agreement with the plaintiff in *Matison*, i.e., to encourage the plaintiff to pursue its possibly uncovered claims against an insured in the hopes of reducing or eliminating the insurer's liability. The jury apparently concluded on the basis of the evidence of the guarantee agreement that NU had engaged in a scheme to benefit at the expense of its insured, and thus breached the covenant of good

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under his property policy for the destruction of his barn, because the report showed the insured's neighbor caused the fire, and the neighbor had a $100,000 liability policy with the same insurer.

[4] California courts have acknowledged, albeit in dicta, that there may be circumstances under which an insurer could be liable to its insured for tortious bad faith even where the insurer has not violated an express provision in its policy. *See McMillin Scripps North Partnership v. Royal Ins. Co. of America*, 23 Cal.Rptr.2d 243, 247 (Cal.Ct.App. 1993) (citing *Rawlings*). Thus, NU's argument that it did not withhold any policy benefits from AMI, even if true, would not preclude AMI's maintenance of an action for bad faith.

faith and fair dealing. This factual finding was based on substantial evidence in the record.

NU raises various coverage defenses based on language in its policy and in the primary policy issued by Harbor. Even assuming, without deciding, however, that NU had a valid coverage defense, AMI would not be excused under this court's reasoning in *Matison* from liability for the breach of its duty not to benefit at the expense of its insured. Thus the validity of NU's coverage defenses is not controlling.

III.

NU also contends the district court erred in rejecting its proposed coverage instructions, which would have had the court tell the jury that (1) NU's obligations under its policy were not triggered because the Harbor policy had not been exhausted, and (2) that the Harbor and National Union policies did not cover claims based on a director's conduct in preventing the acquisition of a corporation. AMI contends that NU withdrew the disputed instructions before a ruling by the district court, thus precluding NU from raising the matter on appeal. *See* Fed. R. Civ. P. 51; *see also Lifshitz v. Walter Drake & Sons, Inc.*, 806 F.2d 1426, 1431 (9th Cir. 1986).

Even assuming the instructions were not withdrawn, however, the district court's refusal to give them has little bearing on this appeal. As already noted, an insurer may be liable for breach of the covenant of good faith and fair dealing even in the absence of any breach of the express provisions of the insurance contract. If NU wanted to dispute coverage it could and should have filed an action for declaratory relief. Instead, it chose to involve itself in the underlying litigation in a way that the jury in the instant bad faith action apparently found to be both self-serving and prejudicial to the interests of NU's insured. This court finds no error in the district court's refusal to give the instructions proffered by NU.

NU further contends that because the district court declined to give the coverage instructions proffered by NU, it should have granted NU's motions for a directed verdict on coverage, because interpretation of the insurance policy was a question of law for the court, not one of fact to be argued by counsel and decided by the jury. The above discussion of the relevance of the coverage issue to the question of bad faith applies with equal force to the motions for directed verdict. This court finds no error in the district court's denial of the motions.

IV.

NU also contends the district court erred in not giving the following instruction on the necessary elements of a tort action for bad faith:

> (1) the contract must be such that the parties are in inherently unequal bargaining positions; (2) the motivation for entering the contract must be a non-profit motivation, i.e., to secure peace of mind, security, future protection; (3) ordinary contract damages are not adequate because (a) they do not require the party in the superior position to account for its actions, and (b) they do not make the inferior party 'whole'; (4) one party is especially vulnerable because of the type of harm it may suffer and of necessity places trust in the other party to perform; and (5) the other party is aware of this vulnerability.

The instruction was drawn from *Wallis v. Superior Court*, 207 Cal.Rptr. 123, 129 (Cal.Ct.App. 1984), a case in which an employee alleged a bad faith breach of an employment contract. The district court rejected the instruction as inapplicable in the context of a suit for insurance bad faith. California courts have held that *every* contract of insurance gives rise to a duty of good faith and fair dealing, the breach of which is a tort. *Downey Sav. & Loan Ass'n v. Ohio Cas. Ins. Co.*, 234 Cal.Rptr. 835 (Cal.Ct.App. 1987), *cert. denied*, 486

U.S. 1036 (1988). Under California law, the size or sophistication of an insured does not affect the insurer's duty of good faith. *See, e.g., Commercial Union Assur. Cos. v. Safeway Stores, Inc.*, 610 P.2d 1038 (Cal. 1980); *Twentieth Century-Fox Film Corp. v. Harbor Ins. Co.*, 149 Cal.Rptr. 313 (Cal.Ct.App. 1978).

NU's reliance on this court's opinion in *Slottow v. American Cas. Co.*, 10 F.3d 1355 (9th Cir. 1993) is misplaced. The portion of *Slottow* cited by NU refers only to the appropriate standard for an award of punitive damages under California law—not for breach of the implied covenant of good faith and fair dealing.

NU's proffered instruction on bad faith does not comport with California law. Accordingly, the district court did not err in refusing to give the instruction.

V.

NU contends that the jury's award of no breach of contract damages and $11 million in bad faith damages "cannot be harmonized rationally, [and thus] the judgment must be vacated and a new trial ordered," citing *Brooks v. Brattleboro Memorial Hosp.*, 958 F.2d 525, 529 (2d Cir. 1992); *Weingart v. Allen & O'Hara, Inc.*, 654 F.2d 1096, 1105-06 (5th Cir. 1981).

In this circuit, however, a court reviewing a jury's special verdict responses for consistency "has a duty to reconcile the jury's special verdict responses on any reasonable theory consistent with the evidence." *Ortiz v. Bank of America NT & SA*, 852 F.2d 383, 388 (9th Cir. 1987). Moreover, "[t]he consistency of the jury verdicts must be considered in light of the judge's instructions to the jury." *Toner v. Lederle Lab.*, 828 F.2d 510, 512 (9th Cir. 1987), *cert. denied*, 485 U.S. 942 (1988).

AMI offers what it contends is a reasonable interpretation of the jury's response on the Special Verdict Form that AMI suffered $0 in breach of contract damages: The jury *did* find that AMI was damaged by the contract

breach in the amount of the $5 million limit on the NU policy *and* that AMI's bad faith damages were $11 million—the combined total reflecting the $16 million settlement between AMI and Pearce. However, the jury believed it was precluded by Instruction No. 37 from awarding both contract and bad faith damages. Instruction No. 37 provided, in pertinent part, that the jury could not "award compensatory damages more than once for the same injury."

The jury's verdict in the instant case is also consistent with this court's holding in *Matison*, and the analysis acknowledged by the California court in *McMillin*, that an insured may recover for bad faith in the absence of a breach of express contract provisions.

The verdict thus may be reconciled on the basis of at least one reasonable theory consistent with the evidence. Accordingly, this court will not vacate the jury award and order a new trial.

VI.

In an insurance bad faith action under California law, an insured may recover only those attorneys' fees attributable to the efforts of the insured's attorneys to recover the benefits due under an insurance contract. *Brandt v. Superior Court*, 693 P.2d 796, 800 (Cal. 1985). Fees attributable to obtaining any part of the plaintiff's award that exceeds the amount due under the policy are not recoverable. *Id.*

NU argues that *Brandt*'s holding precludes an award of attorneys' fees where, as in the instant case, the insured does not obtain an award of contract damages. *Brandt*, however, does not expressly hold as such, but rather speaks of fees attributable to an insured's "efforts" to obtain policy benefits. NU cites no other authority precluding an award of attorneys' fees where a jury fails to award contract damages but awards bad faith damages.

NU also argues that the AMI failed to segregate those fees attributable to pursuit of its claim for policy benefits from the fees attributable to its bad faith claim. AMI, however, notes that its fee witness testified at trial that AMI spent $1,069,000.00 to "secure the benefits under the National Union policy." His testimony was not contradicted.

AMI also notes the court's instruction to the jury on the question of fees:

> If an insurance company breaches its duty of good faith and fair dealing under the insurance policy, then an insured is entitled to recover as damages the reasonable attorneys' fees incurred in seeking to recover the contract benefits of the policy, but not any of the attorneys' fees incurred in seeking the recovery of bad faith damages.

The instruction comports in its essential terms with the model instruction recommended by the California Supreme Court in *Brandt*. *See Brandt*, 693 P.2d at 800. Moreover, the jury's determination of fees is supported by substantial evidence in the record. Accordingly, the jury's award of attorneys' fees will stand.

VII.

We AFFIRM the judgment of the district court.

APPENDIX B

[Filed Jun. 30, 1993]

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

No. 92 0157 ER(Eex)

HONORABLE EDWARD RAFEEDIE

AMERICAN MEDICAL INTERNATIONAL, INC.,
Plaintiff,

vs.

NATIONAL UNION FIRE INSURANCE COMPANY
OF PITTSBURGH, PA.,
Defendant.

JUDGMENT ON SPECIAL JURY VERDICT
(BY DEFENDANT NATIONAL UNION FIRE
INSURANCE COMPANY OF PITTSBURGH, PA.)

This case came on regularly for trial on May 25, 1993 in the Courtroom of the Honorable Edward Rafeedie, United States District Judge presiding. Plaintiff appeared by counsel Ronald M. Oster and Eve M. Codden of the law firm of Paul, Hastings, Janofsky & Walker. Defendant appeared by counsel David E. Reynolds and Jana I. Lubert of the law firm of Lewis, D'Amato, Brisbois & Bisgaard.

A jury of seven persons was regularly impaneled and sworn to try the action. Witnesses on the part of both plaintiff and defendant were duly and properly sworn and examined in person or by deposition testimony. After hearing the evidence and arguments of counsel, the Court instructed the jury and the special verdict issues were sub-

mitted to the jury for answer to such issues. After the jury commenced deliberations, pursuant to the stipulation of the parties, one of the jurors was excused due to illness. The remaining six members of the jury thereafter deliberated and returned into Court with their verdict consisting of special issues submitted to the jury and the answers given thereto, and duly rendered their verdict in writing, words, and figures as follows:

"TITLE OF COURT AND CAUSE"

We, the jury in the above-entitled case, find the following special verdict on the questions submitted to us:

QUESTION NO. 1: Did National Union Fire Insurance Company breach its insurance policy with American Medical International?

Answer "yes" or "no."

Answer: *Yes*

If you answer Question No. 1 "yes," then answer Question No. 2. If you answer Question No. 1 "no," then skip Question No. 2 and proceed to Question No. 3.

QUESTION NO. 2: What are the total amount of American Medical's damages caused by National Union's breach of the insurance policy?

Answer: *$0*

QUESTION NO. 3: Did National Union Fire Insurance Company breach the duty of good faith and fair dealing?

Answer "yes" or "no."

Answer: *Yes*

If you answer Question No. 3 "yes," then answer Question No. 4. If you answer Question No. 3 "no," then skip Question No. 4 and proceed to Question No. 5.

QUESTION NO. 4: What is the total amount of American Medical's damages caused by National Union Fire Insurance Company's breach of the duty of good faith and fair dealing?

Answer: *$11,000,000*

QUESTION NO. 5: What is the total amount of money, including attorneys' fees, that American Medical was reasonably required to spend in this action in order to recover the benefits due under the National Union insurance policy?

Answer: *$1,000,000*

QUESTION NO. 6: Did National Union Fire Insurance Company act with oppression, fraud or malice toward American Medical?

Answer "yes" or "no."

Answer: *No*

Dated: June 4, 1993

/s/ _____

DARYL R. MURPHY

NOW, BY REASON OF SAID SPECIAL VERDICT, IT IS ORDERED, ADJUDGED AND DECREED:

That Plaintiff American Medical International, Inc. have judgment for damages against Defendant National Union Fire Insurance Company of Pittsburgh, PA. ("National Union") caused by National Union's breach of the insurance policy for the sum of $0, have judgment for damages against National Union caused by National Union's breach of the duty of good faith and fair dealing for the sum of $11,000,000, and have judgment for the recovery of monies, both attorneys' fees and costs, spent in order to recover the benefits due under the National Union insurance policy for the sum of $1,000,000, together with costs not already reimbursed by this judgment, and with interest thereon at the legal rate per annum, accruing daily.

Dated: June 30, 1993

/s/ Edward Rafeedie

United States District Court Judge

APPENDIX C

[Filed Jul. 13, 1995]

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 93-56382

D.C. No. CV-92-00157-ER

AMERICAN MEDICAL INTERNATIONAL, INC.,
Plaintiff-Appellee,

v.

NATIONAL UNION FIRE INSURANCE COMPANY
OF PITTSBURGH,
Defendant-Appellant.

ORDER

Before: SCHROEDER and KLEINFELD, Circuit Judges, and KING, District Judge.*

The petition for rehearing filed May 31, 1995, is hereby DENIED.

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* The Honorable Samuel P. King, Senior United States District Judge, for the District of Hawaii, sitting by designation.

APPENDIX D

[Filed Aug. 4, 1995]

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 93-56382

D.C. No. CV-92-157-ER

(Central California)

AMERICAN MEDICAL INTERNATIONAL, INC.,
Plaintiff-Appellee,

v.

NATIONAL UNION FIRE INSURANCE COMPANY
OF PITTSBURGH, PA.,
Defendant-Appellant.

ORDER

Before: SCHROEDER and KLEINFELD, Circuit Judges, and KING,* District Judge.

The motion for a 60-day Stay of Mandate pending filing of a timely petition to the Supreme Court for a writ of certiorari is granted.

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* Honorable Samuel P. King, Senior United States District Judge for the District of Hawaii, sitting by designation.

Supreme Court, U.S.
FILED
OCT 19 1995
CLERK

No. 95-447

IN THE
Supreme Court of the United States
OCTOBER TERM, 1995

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.,
Petitioner,

v.

AMERICAN MEDICAL INTERNATIONAL, INC.,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

BRIEF IN OPPOSITION

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85 pp

COUNTERSTATEMENT OF THE QUESTIONS PRESENTED

1. Whether a federal court, exercising diversity jurisdiction, complies with the requirements of *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938), when it affirms a jury's verdict of state-law breach of contract that is consistent with the substantial evidence, settled principles of state law, and the federal court's own precedent?

2. Whether this Court must grant the petition, vacate the judgment below, and remand for further consideration when (i) the state supreme court has rendered a decision that is not controlling as to the facts and issues of law presented below; and (ii) the court of appeals below has denied a motion for leave to file a petition for rehearing and suggestion for rehearing *en banc* in light of that state supreme court decision?

PARTIES TO THE PROCEEDINGS AND RULE 29 STATEMENT

All parties are listed in the caption. Respondent American Medical International, Inc. is wholly-owned by American Medical Holdings, Inc. Respondent has two non-wholly-owned subsidiaries: Amisub of Texas, Inc. and New Holdings Corp.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1995

No. 95-447

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.,
Petitioner,

v.

AMERICAN MEDICAL INTERNATIONAL, INC.,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

BRIEF IN OPPOSITION

Respondent American Medical International, Inc. ("American Medical") submits this brief in opposition to the Petition for a Writ of Certiorari submitted by National Union Fire Insurance Company of Pittsburgh, Pa. ("National Union").

STATEMENT OF THE CASE

This is a state-law action for breach of a contract of insurance. Petitioner, National Union, seeks review of the United States Court of Appeals for the Ninth Circuit's unpublished and unanimous decision affirming the jury's verdict in favor of Respondent American Medical. The jury concluded after a trial on the merits that National Union breached its contract of insurance issued to American Medical and that National Union violated the duty

of good faith and fair dealing owed to American Medical. The jury awarded American Medical damages of $11 million on the bad faith claim, along with $1 million in attorneys' fees. Petitioner's Appendix ("Pet. App.") 12a-14a.

The Ninth Circuit affirmed the verdict and the judgment in an unpublished and unanimous memorandum decision. Pet. App. 1a-11a. The Ninth Circuit denied National Union's timely petition for rehearing. Pet. App. 16a. On August 4, 1995, the Ninth Circuit granted a 60-day stay of its mandate pending the filing and disposition of National Union's petition for a writ of certiorari to this Court. Pet. App. 17a. Simultaneously with filing its petition before this Court, Petitioner filed a motion with the Ninth Circuit seeking leave to file an untimely petition for rehearing, along with a petition for rehearing and a suggestion for rehearing *en banc*, pursuant to Fed. R. App. P. 26(b), 35 & 40(a), in light of the California Supreme Court's decision in *Waller v. Truck Insurance Exchange*, 11 Cal. 4th 1, 44 Cal. Rptr. 2d 370 (1995).

By order filed on October 6, 1995, the Ninth Circuit denied Petitioner's motion for leave to file the untimely petition.[1]

Factual Background

American Medical owns and operates hospitals and medical research facilities. Pet. App. 2a.[2] In 1988,

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[1] The Ninth Circuit's order is unreported and is reprinted in the appendix hereto ("App.") at 1a. Petitioner's Motion for Leave to File Untimely Petition for Rehearing; Petition for Rehearing and Suggestion for Rehearing En Banc is reprinted at App. at 2a.

[2] Citations in support of this Factual Background are made either to the Ninth Circuit's memorandum decision below, reproduced in the Petitioner's Appendix ("Pet. App."), to the Excerpts of Record filed by National Union with its opening brief before the Ninth Circuit ("EOR"), or to the Supplemental Excerpts of Record filed by American Medical with its brief before the Ninth Circuit ("SUPP").

American Medical purchased two insurance policies to reimburse American Medical should it have to indemnify its directors and officers for claims brought against them in their corporate capacities. *Id.* The first policy, with a limit of $10 million, was issued by the Harbor Insurance Company (the "Harbor Policy"). *Id.* The second policy, with a limit of $5 million excess of $10 million, was issued by National Union (the "National Union Policy"). *Id.* The National Union Policy specifically identifies American Medical as the "Named Insured." *Id.*[3]

Beginning in 1988, American Medical received inquiries and then proposals from parties interested in buying the company. *Id.* The American Medical board of directors therefore formed a Special Committee, chaired by director Harold Williams ("Williams"), to establish procedures for the sale of the company and to review competing bids. *Id.* The Special Committee ultimately conducted an auction with three competing groups submitting proposals to acquire American Medical. *Id.* One of the unsuccessful bidders was an investment group (the "Pearce Group") headed by Lee Pearce ("Pearce"), a former American Medical director. Pet. App. 2a-3a.

In late March and early April of 1989, five class action lawsuits were filed on behalf of American Medical shareholders (the "shareholder actions") and one class action lawsuit was filed by bondholders (the "bondholder action") against American Medical and its current and former directors (collectively the "underlying litigation"), alleging breaches of fiduciary duty in connection with the acceptance of the successful bid for the company. Pet. App. 3a. On May 15, 1989, American Medical notified both Harbor and National Union of the underlying litigation. *Id.*; EOR 216-17. American Medical thereafter provided Harbor and National Union with documents and

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[3] The National Union Policy was an excess "following form" policy that incorporated the terms, conditions and coverage provisions of the underlying Harbor Policy. EOR 166.

information on a regular basis reflecting developments in the proceedings. SUPP 117; EOR 219-21.

On December 14, 1989, American Medical notified National Union of a cross-complaint filed in November of 1989 against American Medical and Williams by Pearce, Pet. App. 3a; EOR 219-21, 248-342, alleging that the Pearce Group had actually submitted a higher bid with fewer risks and fewer contingencies. EOR 311-12. Pearce claimed that Williams had rejected the bid because Williams had a personal animus toward Pearce. *Id.*, at 254.

Between the time of American Medical's notice to National Union in December 1989, and the trial of the Pearce action in June 1991, National Union did nothing to investigate or supervise the case. SUPP 96-97. National Union did not deny coverage or give American Medical any indication as to what position it might take on coverage. *Id.*, at 44-45. Although American Medical had regularly supplied National Union with pleadings, correspondence and memoranda, the National Union official assigned to the case testified at the trial below that he could not recall looking at the file more than once. *Id.*, at 9, 20, 97. The first time that National Union even attempted to reserve its rights occurred less than two weeks before the Pearce trial and consisted of a blanket statement that National Union was reserving "all of our rights" without any specification of the grounds for the reservation. *Id.*, at 6. National Union continued to equivocate as to coverage throughout the trial in this case. National Union's senior claims official testified by way of deposition read at trial that "*We never denied the claim and we are not denying the claim currently.*" *Id.*, at 88 (emphasis added).

While National Union continued to ignore the shareholder and bondholder actions and the Pearce action, American Medical was attempting to bring about a settlement. By letter dated May 31, 1991, American Medical

provided National Union with copies of correspondence in the shareholder actions and the Pearce action relating to settlement. EOR 223-35. American Medical's counsel also provided correspondence from counsel for Continental Insurance Company ("Continental"), the successor to Harbor, in which Continental authorized the use of the full $10 million Harbor Policy limits to settle the shareholder actions. Pet. App. 3a; EOR 234-35.

American Medical also requested that National Union authorize the use of the $5 million National Union Policy limits in the settlement negotiations. Pet. App. 3a; EOR 224. National Union flatly refused to participate in any settlement requiring National Union to pay money:

> "[W]e do not consent to *any settlement* on behalf of directors and officers for which reimbursement is sought under our policy." (Emphasis added.)

Pet. App. 3a; SUPP 6. American Medical and its directors entered into settlements with the plaintiffs in the shareholder actions, using proceeds from the Harbor Policy and a $1.5 million deductible paid by American Medical.[4] SUPP 76.

After National Union rejected American Medical's request to participate in settlement, Williams' attorney, Steven Wilson ("Wilson"), tried without success to obtain authority to use the National Union Policy limits to settle the Pearce action. Pet. App. 3a. On June 25, 1991, Wilson informed National Union that Pearce's counsel had offered to settle with Williams for $5 million, the limits under the National Union Policy. *Id.*; EOR 236. The offer was to remain open for 48 hours. EOR 236. Wilson asked for authority to accept the offer using the National Union Policy limits, but National Union refused again. SUPP 63.

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[4] The bondholder action has previously been dismissed on summary judgment. Pet. App. 3a n.1.

Thus, after doing nothing for more than 18 months, National Union rejected demands from both American Medical and Williams to use the National Union Policy limits for settlement of the Pearce action. EOR 223-24, 236-37. National Union also allowed a $5 million settlement demand to expire without responding. SUPP 8.

After rejecting these demands—and three weeks into the trial on the Pearce action—National Union's lawyer, Robert Lewis ("Lewis"), contacted Pearce's lawyer, Herb Hafif ("Hafif"), and proposed an arrangement, known as a Mary Carter agreement.[5] Pet. App. 3a. Under the terms of the agreement, National Union guaranteed that Hafif's client would recover $5 million in exchange for a dismissal of Williams from the lawsuit. *Id.*, at 4a. The amount guaranteed by National Union was to be reduced—dollar for dollar—by the amount Pearce recovered from American Medical. *Id.* Thus, if Pearce recovered at least $5 million from American Medical, then National Union paid nothing. *Id.*

National Union included a veto provision in the agreement in the event Pearce wanted to settle with American Medical. *Id.* Under this provision, Pearce could not settle with American Medical for less than $4 million without National Union's consent. *Id.* Any settlement with American Medical for less than $4 million would require Pearce to forfeit the $5 million guarantee. *Id.* National Union's lawyer testified at trial that the purpose of the veto provision was to make sure that Pearce and his lawyer continued to sue American Medical and

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[5] As the Ninth Circuit noted in its memorandum decision, "A 'Mary Carter' agreement is an arrangement between a plaintiff and a defendant whereby the exposure to liability of the settling defendant is limited, 'usually in some inverse ratio to the amount of recovery which the plaintiff is able to make against the non-settling defendant or defendants.'" Pet. App. 3a-4a n.2 (citing Black's Law Dictionary 974 (6th ed. 1990)).

to prevent a situation where "all of the [sic] sudden they fold up and say, 'We got five million [from National Union]. Let's go awa[illegible].'" SUPP 52.

Hafif insisted that the settlement be timed to occur when Williams was on the witness stand and under cross-examination by Hafif. *Id.*, at 54. Williams' lawyer testified that the reason for the timing was obvious:

> "That the plaintiff wanted to create a strategic effect in the courtroom that Mr. Williams was on the stand as a defendant, subjected to cross-examination, and was so concerned that he settled, disappeared as a defendant. They thought that would be a powerful motivator or implicit motivator for the jury." [6]

Id., at 74.

When American Medical learned of National Union's deal with Pearce, including the veto provision and the settlement with Williams on the stand, American Medical vehemently objected. *Id.*, at 67. To prevent its insurance benefits from being eviscerated by the deal, American Medical proposed a compromise. *Id.*, at 27. Under American Medical's compromise, National Union would pay $2 million and American Medical would pay $3 million into an escrow account for the defense of Williams who would remain in the case. *Id.*, at 27-28; EOR 344-46. American Medical provided additional assurances of indemnification to Williams—both orally and in writing—to supplement the indemnification agreement already in effect. SUPP 18, 36; EOR 344.

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[6] Similarly, James Roberts, an expert witness, testified at trial that having Williams settle after being cross-examined by Hafif "makes it a much more dangerous case for AMI to continue on with the trial with everybody thinking that Williams has, you know, copped a plea or something. He basically admitted he made a mistake, he acted wrongfully and he paid some money to Mr. Pearce. That has strategic value to Mr. Hafif. It has tremendous strategic impact on AMI in trial tactics and it's very negative." *Id.*, at 104.

Williams strongly preferred the American Medical compromise. SUPP 72. However, National Union refused. *Id.*, at 29. American Medical then requested that National Union at least delay its deal with Pearce to avoid the prejudicial impact at trial of a settlement by Williams while he was on the stand. *Id.*, at 30. National Union refused again. *Id.* The National Union deal with Pearce went forward as planned.

Two weeks into jury deliberations, American Medical settled with Pearce for $16 million. Pet. App. 4a. Because that settlement exceeded the amount guaranteed by National Union to Pearce, National Union was relieved of any obligation to pay Pearce under the Pearce-National Union arrangement. SUPP 15. National Union therefore paid nothing, leaving American Medical to foot the bill for the entire settlement and defense. Pet. App. 4a; SUPP 32, 76-77.

The Actions Below

American Medical filed this diversity action in the United States District Court for the Central District of California, alleging claims for breach of contract and breach of the duty of good faith and fair dealing under California law. The jury concluded, after a trial on the merits, that National Union breached its contract and violated the duty of good faith and fair dealing owed to American Medical. The jury awarded American Medical damages of $11 million on the bad faith claim, along with $1 million in attorneys' fees. Pet. App. 12a-14a. After denying National Union's post-trial motions, the District Court entered judgment, Pet. App. 15a, and National Union appealed.

The Ninth Circuit affirmed the verdict and the judgment in an unpublished and unanimous memorandum decision. Pet. App. 1a. On July 13, 1995, the Ninth Circuit denied National Union's timely petition for rehearing. Pet. App. 16a. On August 4, 1995, the Ninth

Circuit granted a 60-day stay of its mandate pending the filing and disposition of National Union's petition for a writ of certiorari to this Court. Pet. App. 17a. Simultaneously with filing its petition before this Court, Petitioner filed a motion with the Ninth Circuit seeking leave to file an untimely petition for rehearing, along with a petition for rehearing and a suggestion for rehearing *en banc*, pursuant to Fed. R. App. P. 26(b), 35 & 40(a), in light of the California Supreme Court's decision in *Waller v. Truck Insurance Exchange*, 11 Cal. 4th 1, 44 Cal. Rptr. 2d 370 (1995). App. 2a.

By order filed on October 6, 1995, the Ninth Circuit denied Petitioner's motion. App. 1a.

REASONS FOR DENYING THE WRIT

This case presents no issue appropriate for the Court's exercise of its discretionary jurisdiction. This is a straightforward diversity case. The Ninth Circuit affirmed a jury's breach of contract verdict that was based on substantial evidence and settled principles of state law. This Court has repeatedly declined to overrule reasoned decisions by federal courts skilled in the local law of the particular states in which they sit, and this case presents no basis for departing from that principle.

Moreover, contrary to Petitioner's contention, the jury's verdict and the Ninth Circuit's affirmance are not contrary to the California Supreme Court's decision in *Waller v. Truck Insurance Exchange*, 11 Cal. 4th 1, 44 Cal. Rptr. 2d 370 (1995). That decision provides no grounds for vacating the judgment below. In *Waller*, the insurer took no action beyond denying coverage for the uncovered claims presented by its insured. In this case, National Union did not deny coverage. Instead, under the guise of discharging its policy obligations, National Union affirmatively aligned its interests with those of a litigant adverse to American Medical, its own insured. Direct damage to American Medical resulted and American

Medical was deprived of the insurance benefits to which it was entitled. California and the Ninth Circuit precedent squarely supports the jury's finding of bad faith in this case. *Waller* does not hold otherwise. Indeed, the Ninth Circuit itself has already refused to reconsider its decision in this case in light of *Waller*. App. 1a. The petition accordingly should be denied.

I. NO ISSUE OF INTER-CIRCUIT CONFLICT IS RAISED BY THE DECISION BELOW.

National Union asserts that this case presents the Court with the question of whether a federal court, exercising diversity jurisdiction, exceeds its authority when it "creates a new state law cause of action not previously recognized by the courts or authorized by the legislature of the State." Pet. at (i). Whatever might be the significance of that question, this case does not present it. Specifically, the fundamental premise of National Union's petition—that the Ninth Circuit in this case created a new California cause of action—simply is not correct. The court of appeals neither expressly nor impliedly engaged in what the petition terms an "*Erie* guess" in this case. Instead, the court applied established California and Ninth Circuit law and affirmed a jury verdict that was firmly based on the substantial evidence adduced at trial. This Court has prudently restrained from exercising its discretionary jurisdiction to review questions of state law that are better addressed by the federal judges who sit in the districts and circuit located in the state. No question requiring grant of the petition is raised here.

A. The Ninth Circuit Followed The Dictates Of *Erie* In Affirming The Jury's Verdict Based On Established Precedent.

Petitioner has attempted to cast the Ninth Circuit's affirmance of the jury's verdict in this case as the invention of "an entirely new cause of action not previously recognized in California." Pet. at 6. From this erroneous

premise, Petitioner fashions the argument that certiorari must be granted in this case to resolve an alleged split among the federal circuit courts as to the appropriate role of a federal court addressing questions of state law when sitting in diversity.

However, this case does not present that question, because this is not an instance in which a federal court sitting in diversity has recognized a new cause of action unrecognized by the courts of the state in which the case arises.[7] Instead, as described below, the Ninth Circuit examined the facts of this case, the law of California and applicable Circuit precedent and affirmed the judgment squarely on those grounds.

In rejecting Petitioner's objections to the jury's verdict, the Ninth Circuit analyzed California cases, including decisions of the California Supreme Court and intermediate courts of appeal.[8] The Ninth Circuit also reviewed analogous decisions from other jurisdictions as well as a virtually identical Ninth Circuit case that relied on principles derived from California insurance law.[9] In doing so, the Ninth Circuit heeded this Court's dictate in *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938), and its progeny, that a federal court exercising diversity jurisdiction must

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[7] The Ninth Circuit is fully aware of the distinction between applying established state law and recognizing when state law on the issue presented is unsettled. *See, e.g., Torres v. Goodyear Tire & Rubber Co.*, 867 F.2d 1234, 1238 (9th Cir. 1989); *Paul v. Watchtower Bible & Tract Soc'y of New York*, 819 F.2d 857, 879 (9th Cir.), *cert. denied*, 484 U.S. 926 (1987). Unlike in those cases, here the Ninth Circuit applied existing California law and its own precedent to resolve the issues presented on appeal.

[8] *See* Pet. App. 5a-10a (citing, *inter alia*, *Commercial Union Assur. Cos. v. Safeway Stores, Inc.*, 610 P.2d 1038 (Cal. 1980), and *McMillin Scripps North Partnership v. Royal Ins. Co. of America*, 23 Cal. Rptr. 2d 243, 247 (Cal.Ct.App. 1993), *rev. denied*, 1994 Cal. LEXIS 552 (Cal. Feb. 3, 1994)).

[9] *Matison v. Transamerica Title Ins. Co.*, 845 F.2d 867 (9th Cir. 1988) (discussed *infra*).

follow the substantive law of the state in which the action was brought. The Ninth Circuit satisfied this obligation by "look[ing] to all available data," *State Farm Mut. Auto Ins. Co. v. Davis*, 937 F.2d 1415, 1418 (9th Cir. 1991), including decisions of a state's highest court, intermediate court decisions, and well-reasoned decisions from other jurisdictions. *Id.*

Accordingly, the appropriate question presented by this case is whether a federal court, exercising diversity jurisdiction, complies with the requirements of *Erie R.R. v. Tompkins* when it affirms a jury's verdict of breach of contract that is consistent with the substantial evidence, settled principles of state law, and the federal court's own precedent. This is a question which this Court has prudently determined is not appropriate for review. *See, e.g., Butner v. United States*, 440 U.S. 48, 57-58 (1979) ("[t]he federal judges who deal regularly with questions of state law in their respective districts and circuits are in a better position than we to determine how local courts would dispose of comparable issues"); *Bishop v. Wood*, 426 U.S. 341, 346 and n.10 (1976) (construction of state law by federal district court and court of appeals would not be reviewed, as " 'we are hesitant to overrule decisions by federal courts skilled in the law of particular states unless their conclusions are shown to be unreasonable' ") (internal citations omitted). In this case, the jury's verdict, the District Court's judgment and the Ninth Circuit's affirmance were all based on a correct application of state law. This Court should deny Petitioner's invitation to upset that analysis in this case.

B. The Ninth Circuit Correctly Applied The Law In This Case.

National Union's assertion that the Ninth Circuit created a new California cause of action is not correct. The Ninth Circuit affirmed the jury's finding of bad faith based on the substantial evidence, California law and the almost identical precedent contained in its decision in

Matison v. Transamerica Title Ins. Co., 845 F.2d 867 (9th Cir. 1988). In *Matison*, as in this case, the insurer entered into an agreement with the plaintiff against its insured -whereby the amount the insurer agreed to pay under its policy would be reduced dollar for dollar by any recovery that the plaintiff obtained on uncovered claims against the insured. The Ninth Circuit held that an insurer breaches the duty of good faith and fair dealing by entering into such an agreement, which furthers its own interests at the expense of its insured's interest: "Such connivance against one's insured is incompatible with the fiduciary-like duty an insurer . . . assumes by issuing a contract of insurance. Transamerica wrongfully placed 'paramount importance on its own interest.'" *Matison, supra*, at 868 (citations omitted).

National Union suggests that *Matison*, which is an Arizona case, cannot provide a basis under California law for the jury's finding of bad faith here. Pet. at 16. What National Union fails to note is that the principles of bad faith underlying the Ninth Circuit's decision in *Matison* are drawn primarily from California law. In ruling that the self-interested agreement negotiated by the insurance company in *Matison* was improper, the Ninth Circuit cited the Arizona Supreme Court case of *Rawlings v. Apodaca*, 151 Ariz. 149, 726 P.2d 565, 571, 573 (1986), and held that Transamerica had "a duty 'of a fiduciary nature' not to benefit at the expense of its insured." *Matison, supra*, at 868. The *Rawlings* court, in turn, relied on the *California* Supreme Court decision in *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 169 Cal. Rptr. 691 (1979), *cert. denied and appeal dismissed*, 445 U.S. 912 (1980), for the proposition that "the insurance contract and the relationship it creates contain more than the company's bare promise to pay certain claims when forced to do so; implicit in the contract and the relationship is the insurer's obligation to play fairly with its insured." *Rawlings, supra*, at 570-71. The *Rawlings* court also noted *Egan's* rule that "[c]on-

duct by the insurer which does destroy the security or impair the protection purchased breaches the implied covenant of good faith and fair dealing implied in the contract." *Id.*, at 571 (citing *Egan*). As noted in the Ninth Circuit's decision, California courts have recognized the applicability of the *Rawlings* analysis under California insurance bad faith law. *See* Pet. App. at 6a n.4, citing *dicta* in *McMillin Scripps North Partnership v. Royal Ins. Co. of America*, 19 Cal. App. 4th 1215, 1223, 23 Cal. Rptr. 2d 243, *reh'g denied*, 1993 Cal. App. LEXIS 1102 (1993) and *rev. denied*, 1994 Cal. LEXIS 552 (Cal. Feb. 3, 1994).[10]

Any fair reading of the decision below does not support National Union's contention that the Ninth Circuit extended California law or created a new cause of action. Rather, in reviewing the jury's verdict under the applicable "substantial evidence" standard, the court below applied bad faith principles established by the California Supreme Court some fifteen years ago, in *Egan*, to the facts presented here. *Landes Constr. Co. v. Royal Bank of Canada*, 833 F.2d 1365, 1371 (9th Cir. 1987) (applicable standard of review is "substantial evidence").

Accordingly, no basis exists for this Court to exercise its jurisdiction and upset the judgment below.

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[10] The Ninth Circuit cited *McMillin Scripps North Partnership* in connection with its statement that "California courts have acknowledged, albeit in dicta, that there may be circumstances under which an insurer could be liable to its insured for tortious bad faith even where the insurer has not violated an express provision in its policy." Pet. App. at 6a n.4. In this case, by contrast, the jury expressly found that National Union had breached its policy.

II. THE CALIFORNIA SUPREME COURT DECISION CITED BY THE PETITIONER DOES NOT REQUIRE VACATUR OF THE JUDGMENT BELOW.

Contrary to Petitioner's contention, the California Supreme Court's decision in *Waller v. Truck Insurance Exchange*, 11 Cal. 4th 1, 44 Cal. Rptr. 2d 370 (1995), is not controlling as to the issues decided by the Ninth Circuit below. Accordingly, there is no basis to grant Petitioner's request to vacate the judgment below. The Ninth Circuit apparently agrees. Two weeks ago, that court denied National Union's motion for leave to file an untimely petition for rehearing and suggestion of rehearing *en banc* in light of the *Waller* decision.

Waller provides no ground to upset the jury's verdict in this case. *Waller* stands for the proposition that an insurer which *denies coverage* and refuses to defend its insured or otherwise get involved in a case where there is no potential for coverage cannot be held liable for bad faith. Here, National Union never denied coverage, and it certainly did not refrain from taking action in the underlying litigation. Instead, National Union affirmatively injected itself into the underlying litigation against American Medical and its director, Harold Williams, in order, as the jury found, to minimize its liability and prejudice American Medical, its insured. As the Ninth Circuit specifically noted, "[i]f [National Union] wanted to dispute coverage it could and should have filed an action for declaratory relief. Instead, it chose to involve itself in the underlying litigation in a way that the jury in the instant bad faith action apparently found to be both self-serving and prejudicial to the interests of [National Union's] insured." Pet. App. 7a.

Waller does not preclude a bad faith claim where, as here, an insurer purportedly provides benefits under the guise of the policy but in reality uses the policy to affirmatively damage its insured.

Moreover, the unstated premise of National Union's argument—that there was no coverage—is directly con-

trary to National Union's own conduct and the jury's special verdict finding that National Union in fact breached its contract of insurance. National Union's coverage defenses—the same ones it asserts here—were properly rejected by the jury and by the District Court in denying National Union's post-trial motions. These findings were supported by more than substantial evidence. The Ninth Circuit affirmed, and there is no reason to vacate that decision here.

A. The Ninth Circuit Has Determined That Petitioner's Arguments Based On The California Supreme Court's *Waller* Decision Do Not Constitute Good Cause To Grant Leave To Seek Rehearing In That Court.

The thrust of National Union's entire petition is that the Ninth Circuit's application of California law would have resulted in a reversal of the jury's verdict if only the court had had the benefit of the *Waller* decision at the time of the appeal. However, National Union has already provided the Ninth Circuit with that decision and the identical arguments it makes here in a motion filed with the Ninth Circuit simultaneously with the filing of this petition. App. 2a. In the motion, National Union sought leave to file an untimely petition for rehearing, along with a petition for rehearing and a suggestion for rehearing *en banc*, pursuant to Fed. R. App. P. 26(b), 35 & 40(a). In that pleading, Petitioner presented to the Ninth Circuit the identical argument that the *Waller* decision requires reconsideration of its memorandum decision in this case. App. 2a. By order filed on October 6, 1995, the Ninth Circuit denied Petitioner's motion. App. 1a.

The Ninth Circuit's denial underscores the correctness of the decision below and illustrates that *Waller* simply is not applicable to the facts and legal issues presented in this case.

B. The *Waller* Decision Is Inapplicable To The Matters At Issue Here.

In its petition, National Union attempts to stretch *Waller* beyond the scope of the holding in that decision. In fact, *Waller* provides no basis to overturn the jury's verdict in this case. In *Waller*, the California Supreme Court granted review to determine "whether a commercial general liability insurer is required to defend a third party action that seeks incidental emotional distress damages caused by the insured's noncovered economic or business torts." 44 Cal. Rptr. 2d at 372. The Court held that the insurer had no duty to defend the action because those claims raised no potential for coverage under the bodily injury or property damage coverage grants in a general liability policy. The Court also held that a bad faith claim could not exist absent this *potential* for coverage. "It is clear that if there is no *potential* for coverage and, hence, no duty to defend under the terms of the policy, there can be no action for breach of the implied covenant of good faith and fair dealing because the covenant is based on the contractual relationship between the insured and the insurer." *Id.*, at 390 (emphasis in original) (citing *Love v. Fire Ins. Exchange*, 221 Cal. App. 3d 1136, 1151-53, 271 Cal. Rptr. 246, *reh'g denied*, 1990 Cal. LEXIS 4195 (1990)). Thus, the Court held that a bad faith claim cannot be maintained in that situation "unless policy benefits are due." *Id.*

National Union's effort to expand *Waller* beyond its holding to cover this case should be rejected. National Union's conduct is far different from that of the insurer in *Waller*, who did nothing more than deny a defense for what turned out to be a non-covered claim in any event. National Union never denied coverage for American Medical's claim.[11] Instead, National Union intruded itself

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[11] National Union's senior claims official testified by way of deposition read at the trial that "*We never denied the claim and we are not denying the claim currently.*" Supp. 88 (emphasis added).

into the underlying case and entered into an agreement that severely *prejudiced* its insured. Through its Mary Carter arrangement, National Union gave the underlying plaintiff an incentive to pursue American Medical with more vigor due to the guaranteed liability agreement, and indeed, put American Medical in a *worse* position than it would have been had National Union taken no action at all, *i.e.*, had National Union merely denied coverage and taken no further action, like the insurer in *Waller*.

The jury's finding of bad faith under the facts of this case was firmly grounded in California and Ninth Circuit precedent. As the Ninth Circuit stated: "[National Union's] guarantee agreement with Pearce [the underlying plaintiff] had essentially the same effect as Transamerica's agreement with the plaintiff in *Matison* [*v. Transamerica Title Ins. Co.*, 845 F.2d 867 (9th Cir. 1988)], *i.e.*, to encourage the plaintiff to pursue its possibly uncovered claims against an insured in the hopes of reducing or eliminating the insurer's liability." Pet. App. 6a. The Ninth Circuit thus found that, because the jury could reasonably have concluded on the evidence that National Union "had engaged in a scheme to benefit at the expense of its insured," substantial evidence supported the bad faith finding against National Union. Pet. App. 6a-7a.

Thus, unlike the insurer in *Waller*, National Union did not deny coverage, but cut a separate deal with the underlying plaintiff, at the expense of its own insured, American Medical. National Union was held liable for breach of contract and bad faith based on more than substantial evidence. Nothing in *Waller* forecloses a California court from imposing bad faith liability against an insurer where the insurer actively engages in misconduct designed to benefit itself and cause detriment to its insured.[12]

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[12] The proposition that an insurer that takes unreasonable action injurious to its insured can be liable for bad faith has been recognized in more than one California decision. *See, e.g., McMillin*

C. Even If *Waller* Were Otherwise Applicable It Would Not Change The Result In This Case.

National Union's petition obviously implies that there was no coverage under its policy for the underlying claim. Here, however, unlike the situation in *Waller*, there *was* coverage under the policy. National Union presented each of its coverage arguments during the trial, again to the District Court in post-trial motions, and to the Ninth Circuit on appeal. In each case, the arguments were rejected, and for good reason. The underlying Pearce litigation presented exactly the type of claim covered by National Union's policy, and National Union repeatedly took the position that it was fulfilling its obligations under the policy. National Union's representatives never denied coverage during the pendency of the Pearce litigation, and National Union's senior claims representative testified at the trial below that National Union still was not denying coverage for the claim. In fact, National Union maintained at trial and on appeal that it *had* provided policy benefits by entering into the Mary Carter agreement against its own insured.

The jury explicitly found that National Union had breached its insurance contract and the implied covenant of good faith and fair dealing in taking the action against American Medical. Pet. App. 13a. After denying National Union's post-trial motions, the District Court entered judgment on the jury's verdict. Pet. App. 15a. The Ninth Circuit affirmed the verdict, which it found to be based on substantial evidence. Pet. App. 7a. National Union's attempt to rely on California precedent (including *Waller*) addressing the viability of a claim for breach of the covenant of good faith and fair dealing in the absence of the *potential* for coverage under the policy is thus wholly misplaced here.

Scripps North Partnership, supra; Murray v. State Farm Fire & Cas. Co., 219 Cal. App. 3d 58, 65-66, 268 Cal. Rptr. 33 (1990).

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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APPENDICES

APPENDIX A

[Filed Oct. 6, 1995]

IN THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 93-56382

D.C. No. CV-92-157-ER
(Central California)

AMERICAN MEDICAL INTERNATIONAL, INC.,
Plaintiff-Appellee,

v.

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.,
Defendant-Appellant.

ORDER

Before: SCHROEDER and KLEINFELD, Circuit Judges, and KING,* District Judge.

The Motion for Leave to File Untimely Petition for Rehearing; Petition for Rehearing and Suggestion for Rehearing En Banc is DENIED.

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* Honorable Samuel P. King, Senior United States District Judge for the District of Hawaii, sitting by designation.

APPENDIX B

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

93-56382

AMERICAN MEDICAL INTERNATIONAL, INC.,
Plaintiff and Appellee,

vs.

NATIONAL UNION FIRE INSURANCE COMPANY
OF PITTSBURGH, PA.,
Defendant and Appellant.

Appeal from the United States District Court
for the Central District of California
Case No. CV 92-157-ER(EEx)
Edward Rafeedie, Judge

MOTION FOR LEAVE TO FILE UNTIMELY PETITION FOR REHEARING; PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

[Fed. R. App. P. 26(b), 35 & 40(a)]

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IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

93-56382

AMERICAN MEDICAL INTERNATIONAL, INC.,
Plaintiff and Appellee,

vs.

NATIONAL UNION FIRE INSURANCE COMPANY
OF PITTSBURGH, PA.,
Defendant and Appellant.

MOTION FOR LEAVE TO FILE UNTIMELY PETITION FOR REHEARING; PETITION FOR REHEARING AND SUGGESTION FOR REHEARING EN BANC

[Fed. R. App. P. 26(b), 35 & 40(a)]

INTRODUCTION AND STATEMENT OF COUNSEL

Defendant and appellant National Union Fire Insurance Company of Pittsburgh, Pa. ("National Union") requests leave to file an untimely petition for rehearing. In the opinion of counsel, leave to file an untimely petition for rehearing should be granted so that the panel can reconsider its May 17, 1995 memorandum of decision in light of *Waller v. Truck Insurance Exchange,* No. S042287, 1995 WL 516406 (Cal. Aug. 28, 1995), a recent decision by the California Supreme Court which establishes this court erred in recognizing a new state law

cause of action. *See Huddleston v. Dwyer*, 322 U.S. 232, 236 (1944); *Braniff Airways, Inc. v. Curtiss-Wright Corp.*, 424 F.2d 427, 429-30 (2d Cir. 1970), *cert. denied sub. nom. Addabbo v. Curtiss- Wright Corp.*, 400 U.S. 829 (1970).

In its memorandum of decision, the panel affirmed a $12 million judgment in favor of plaintiff and appellee American Medical International, Inc. ("American Medical") in a diversity action for breach of insurance contract and breach of the implied covenant of good faith and fair dealing. In that action, American Medical claimed National Union breached the good faith covenant in an excess directors and officers liability policy by settling a suit against an American Medical director, Harold Williams, over American Medical's objection.

National Union argued, inter alia, the judgment should be reversed because it owed no policy benefits to either American Medical or Williams and because the district court refused to either instruct the jury or grant National Union's motions for directed verdict on its policy's coverage. The panel rejected those arguments and declined to address the coverage issues. Relying on dictum in an intermediate California Court of Appeal decision and a decision of this court which applied *Arizona* law, the panel held that under California law, an insurer may be found liable for breach of the implied covenant even if no policy benefits are owed.

On July 13, 1995, the panel denied National Union's timely petition for rehearing. On August 4, 1995, however, the panel granted a 60-day stay of mandate pending the filing and disposition of a petition for certiorari to the United States Supreme Court. National Union's petition for certiorari was filed on September 15, 1995.

On August 28, 1995, the California Supreme Court filed its opinion in *Waller*. *Waller* specifically held that under California law, an action for breach of the implied

covenant of good faith and fair dealing cannot be maintained in the absence of a duty to defend or indemnify.

Because *Waller* establishes that the panel erred in concluding the California Supreme Court would recognize a cause of action for breach of the implied covenant in an insurance contract when no policy benefits are owed, the panel is obligated under controlling Supreme Court precedent to grant National Union's motion to file an out-of-time petition for rehearing and reconsider its earlier ruling. *Huddleston*, 322 U.S. at 236. If the panel denies rehearing, the court should rehear this matter en banc to conform Ninth Circuit law with the rule articulated by the Supreme Court that, so long as the case remains sub judice, a federal court of appeals sitting in diversity is obligated to consider an out-of-time petition for rehearing when an intervening state court decision calls into question the court of appeals' understanding of state law. *See Carter v. Derwinski*, 987 F.2d 611, 613-15 (9th Cir. 1993) (en banc) (overruling circuit precedent inconsistent with prior supreme court authority).

LEGAL DISCUSSION

I. THIS COURT IS OBLIGATED TO GRANT LEAVE TO FILE AN UNTIMELY PETITION FOR REHEARING WHEN AN INTERVENING STATE COURT DECISION CALLS INTO QUESTION THIS COURT'S UNDERSTANDING OF STATE LAW. THE COURT SHOULD GRANT LEAVE EVEN THOUGH A PETITION FOR CERTIORARI IS PENDING.

A party ordinarily has fourteen days from entry of judgment to file a petition for rehearing. Fed. R. App. P. 40(a). This time period may be enlarged, however, upon "good cause shown." Fed. R. App. P. 26(b); *see also* Fed. R. App. P. 35(c), 40(a). Supreme Court precedent establishes that a federal court of appeals sitting in diversity not only may but *must* consider an out-of-time petition for rehearing when an intervening state court de-

cision calls into question the federal court's understanding of state law so long as the federal case is still sub judice.

The leading case is *Huddleston v. Dwyer*, 322 U.S. 232 (1944). *Huddleston* involved a diversity action that turned on application of Oklahoma law. Following entry of judgment in the Tenth Circuit, defendants filed a timely petition for rehearing that was denied. A month and a half later, the Oklahoma Supreme Court handed down a decision that cast doubt on the Tenth Circuit's understanding of Oklahoma law. Defendants then sought leave to file a second, untimely petition for rehearing with the Tenth Circuit. That petition was also denied. Applying the rule that " '[u]ntil such time as [the] case is no longer sub judice, the duty rests upon federal courts [exercising diversity jurisdiction] to apply state law . . . in accordance with the then controlling decision of the highest state court,' " *id.* at 236 (second alteration in original) (quoting *Vandenbark v. Owens-Illinois Glass Co.*, 311 U.S. 538, 543 (1941)), the United States Supreme Court vacated the Tenth Circuit judgment and remanded with instructions for the court of appeals to reconsider its decision in light of the intervening state law decision, *id.* at 237-38.[1]

In *Braniff Airways, Inc. v. Curtiss-Wright Corp.*, 424 F.2d 427 (2d Cir. 1970), *cert. denied sub nom. Addabbo v. Curtiss-Wright Corp.*, 400 U.S. 829 (1970), the Second Circuit, following *Huddleston*, considered an

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[1] The Supreme Court reaffirmed the propriety of this practice more recently in *Exxon Co., U.S.A. v. Banque de Paris et des Pays-Bas*, 488 U.S. 920 (1988). There the Fifth Circuit, in a diversity case, issued a decision turning on a question of Texas law. Thereafter, the Texas Court of Appeals, in a different case, decided the question contrary to the Fifth Circuit's understanding of Texas law. The losing party before the Fifth Circuit petitioned the Supreme Court for a writ of certiorari, which the court granted. After briefing, the Supreme Court vacated the Fifth Circuit judgment and remanded for further consideration in light of the intervening state court decision.

out-of-time petition for rehearing under a fact pattern virtually identical to that presented by this case. *Braniff* involved a diversity action that turned on application of Florida law. Following entry of judgment in the Second Circuit, defendants filed a timely petition for rehearing. Three weeks after the petition was denied, the Florida Supreme Court reversed a lower court decision upon which the court of appeals had relied in construing state law. Defendants filed a petition for certiorari and later filed a request in the court of appeals for " 'modification of decision of the court or for enlargement of the time to petition for rehearing.' " *Braniff Airways, Inc.*, 424 F.2d at 429 (quoting plaintiffs' motion). After the Supreme Court denied certiorari, the Second Circuit granted the request for rehearing.

The court first held it had

> the power to enlarge the time to petition for rehearing . . . and to modify an erroneous decision although the time for rehearing may have expired. . . .
>
> This Circuit has long shown considerable willingness to correct what it believed an erroneous interpretation of the law when an intervening state decision seemed to indicate a better view.

Id. at 429.

The court then considered whether it should entertain a request for rehearing when a petition for certiorari had already been filed:

> *Huddleston* seems to indicate that we should. Instead of reversing the court of appeals, and deciding the state law issues itself, the Supreme Court there vacated the court of appeals decision, and remanded to that court to permit it to determine the issues of state law in the first instance, on the basis of the new state court decision. *For us to refuse to consider petitions for rehearing under the circumstances present*

> *here merely because a petition for certiorari has been filed would be, it seems to us, wasteful, for under the* Huddleston *procedure the Supreme Court would not reach the merits of the controversy, but would vacate our decision and order us to reconsider on the basis of the recent state opinion.*

Id. at 429-30 (emphasis added).[2]

In sum, under *Braniff*, this case remains sub judice and the court must entertain an out-of-time petition for rehearing even though a petition for certiorari has been filed. (Indeed, because the panel in this case stayed the mandate for only 60 days pending the filing of a petition for certiorari, it was necessary for National Union to file its petition for certiorari to prevent the mandate from issuing.) Under *Huddleston*, the panel is obligated to reconsider its prior decision if the California Supreme Court's decision in *Waller v. Truck Insurance Exchange* at least calls that ruling into question. It plainly does, for the reasons set forth in Part II below.

We urge the panel to promptly reconsider its ruling in light of *Waller*, thereby fulfilling its *Huddleston* obligation and forestalling the "wasteful" scenario outlined in *Braniff*, i.e., a grant of certiorari by the Supreme Court, followed by vacatur of the panel's judgment and remand for reconsideration in light of *Waller*. However, as *Braniff*

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[2] *See also* 2A Federal Procedure, Lawyers Edition § 3:840, at 479 (1994) (citations omitted).

> [A] Court of Appeals does have . . . the power to modify an erroneous decision, even though the time for a rehearing may have expired. It has even been held that a Court of Appeals has the power to consider a petition for rehearing, although a petition for certiorari has already been filed with the Supreme Court, since it is less wasteful of judicial effort for the Court of Appeals to grant the rehearing than it is for the Court of Appeals to wait for the Supreme Court to vacate its judgment and remand.

Id.

establishes, the court retains the authority to entertain and grant the petition for rehearing even if the Supreme Court denies certiorari before a ruling on the rehearing petition.

II. THE CALIFORNIA SUPREME COURT'S OPINION IN *WALLER* ESTABLISHES THAT THE PANEL ERRED IN CONCLUDING THE CALIFORNIA SUPREME COURT WOULD RECOGNIZE A BAD FAITH CAUSE OF ACTION WHERE NO POLICY BENEFITS ARE OWED.

In its appeal, National Union argued that under California law, it could not be liable for breach of the implied covenant of good faith and fair dealing if no policy benefits were owed. It contended no policy benefits were owed to either Williams or American Medical because: (a) the $10 million limits of the underlying primary policy were not exhausted; (b) the National Union directors and officers liability policy expressly excluded claims arising out of acts to prevent the acquisition of the corporation and claims by former directors; and (c) the policy entitled American Medical to benefits only if American Medical indemnified Williams for his liability, which American Medical had refused to do. National Union also contended the district court committed reversible error by refusing to either instruct the jury or grant its motions for directed verdict on its policy's coverage.

The panel found it unnecessary to address National Union's coverage arguments. It held that under California law, an insurer may be liable to its insured for breach of the implied covenant even if it did not withhold any policy benefits from American Medical. (Mem. of Decision at 6 n.4, 7-8.) The panel based its conclusion solely on dictum in *McMillin Scripps North Partnership v. Royal Insurance Co. of America*, 23 Cal. Rptr. 2d 243, 247 (Cal. Ct. App. 1993), an intermediate California Court of Appeal decision, "that 'there may be unusual

circumstances' " in which bad faith liability could be imposed where no policy benefits were owed, and *Matison v. Transamerica Title Insurance Co.*, 845 F.2d 867 (9th Cir. 1988), a decision which applied *Arizona* law.

Waller v. Truck Insurance Exchange, No. S042287, 1995 WL 516406 (Cal. Aug. 28, 1995), decided after the panel denied National Union's earlier petition for rehearing, establishes that *Matison* and the dictum in *McMillin* are contrary to California law. In *Waller*, the insurer refused to defend its insureds in a business dispute over corporate control. The insureds sued the insurer claiming, inter alia, that its denial of a defense breached the implied covenant of good faith and fair dealing. After determining that the insurer was under no duty to defend or indemnify, the California Supreme Court affirmed the holding of the court of appeal that there could be no breach of the implied covenant in the absence of obligations under the policy. It held:

> [I]f there is no *potential* for coverage and, hence, no duty to defend under the terms of the policy, there can be no action for breach of the implied covenant of good faith and fair dealing because the covenant is based on the contractual relationship between the insured and the insurer. . . . [The] "conclusion that a bad faith claim cannot be maintained unless policy benefits are due is in accord with the policy in which the duty of good faith is [firmly] rooted." . . . The legal principle is based on general contract law and the long-standing rule " 'that neither party will do anything which will injure the right of the other to receive the benefits of the agreement.' " . . . In sum, the covenant is implied as a supplement to the express contractual covenants, to prevent a contracting party from engaging in conduct that frustrates the other party's rights to the benefits of the agreement . . . *Absent that contractual right . . . the implied covenant has nothing upon which to act as a supplement, and "should not be endowed with an*

> *existence independent of its contractual underpinnings."*

Id. at *21 (citations omitted) (third alteration in original).

Thus, the California Supreme Court has clearly and squarely rejected the interpretation of California law adopted in the panel's May 17, 1995 memorandum decision. That decision is not " 'in accordance with the . . . controlling decision of the highest state court' " and must be reconsidered. *Huddleston v. Dwyer,* 322 U.S. at 236 (quoting *Vandenbark v. Owens-Illinois Glass Co.,* 311 U.S. at 543). This court is therefore obligated to grant National Union's motion and petition and "conform [its] order[] to the state law." *Vandenbark,* 311 U.S. at 543.

CONCLUSION

For all the foregoing reasons, the motion for leave to file an untimely petition for rehearing should be granted so that the panel may promptly reconsider its decision in light of the California Supreme Court's decision in *Waller v. Truck Insurance Exchange,* thereby obviating the need for the Supreme Court to grant National Union's pending petition for certiorari and remand the case for reconsideration under *Waller.*

If the panel denies rehearing, the court should rehear this matter en banc to conform Ninth Circuit law with the rule articulated by the Supreme Court in *Huddleston v. Dwyer* that a federal court of appeals must follow the controlling decision of the highest state court and must consider an out-of-time petition for rehearing when an intervening state court decision calls into question the federal court's understanding of state law.

Dated: September 20, 1995

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(3)

No. 95-447

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IN THE
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OCTOBER TERM, 1995

NATIONAL UNION FIRE INSURANCE COMPANY OF PITTSBURGH, PA.,
Petitioner,
v.
AMERICAN MEDICAL INTERNATIONAL, INC.,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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REPLY BRIEF FOR PETITIONER

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1. Respondent AMI's opposition to certiorari is more noteworthy for what it does not say than what it says.[1] AMI does not dispute that there is a conflict among the circuits over whether a federal court sitting in diversity may create a new state law cause of action not previously recognized by the courts or authorized by the legislature of the State. Nor could it. The Ninth Circuit itself has expressly acknowledged that, "[f]or better or for worse," it departs from "the rule in other circuits" on this question. *Torres* v. *Goodyear Tire & Rubber Co.*, 867 F.2d 1234, 1238 n.1 (9th Cir. 1989). In addition, AMI has no response to our showing in the petition that the Ninth Circuit's activist approach is contrary to the basic principles underlying *Erie R. Co.* v. *Tompkins*, 304 U.S. 64 (1938),

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[1] Petitioner's Rule 29.6 statement appears at Pet. ii.

nor does AMI dispute that the issue arises repeatedly and should be resolved by this Court.[2]

Instead AMI argues that the Ninth Circuit did not create new state law in this case but simply applied existing law. The Ninth Circuit's opinion itself goes far in refuting this assertion; the most that the panel below claimed was that there was dicta indicating there "may" be circumstances in which an insurer "could" be liable for bad faith even in the absence of a violation of its policy. Pet. App. 6a n.4.[3] In any event, the intervening decision of the California Supreme Court in *Waller* v. *Truck Insurance Exchange, Inc.*, 11 Cal. 4th 1, 44 Cal. Rptr. 2d 370 (1995), confirms that the panel in this case was not simply applying existing California law, but instead—mistakenly—creating a new cause of action. *See* Pet. 22-23; *see also infra* at 4-5. The persistent and acknowledged conflict among the circuits on the question whether a federal diversity court may make new state law plainly needs to be resolved by this Court; there could be no better vehicle than a case in which the Ninth Circuit's activist approach led it to a construction of state law that was rejected by the pertinent state supreme court while the federal case was still *sub judice*.

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[2] Prominent examples of the Ninth Circuit's approach—which it recognizes conflicts with the "posture of restraint" that characterizes the approach of other circuits, *Torres*, 867 F.2d at 1238 n.1—continue to multiply, precipitating calls for guidance from this Court. *See, e.g., St. Paul Fire & Marine Ins. Co.* v. *F.H.*, 55 F.3d 1420 (9th Cir. 1995) (decision in diversity case recognizing novel exception to Alaska rule precluding insurance coverage for intentional injuries), *pet. for cert. pending*, No. 95-594 (filed October 11, 1995).

[3] The panel cited one intermediate California case for this assertion—*McMillin Scripps North Partnership* v. *Royal Ins. Co. of America*, 19 Cal. App. 4th 1215, 23 Cal. Rptr. 2d 243 (1993)—but the court in that case in fact confirmed the well-settled California rule that "a bad faith claim cannot be maintained unless policy benefits are due." 19 Cal. App. 4th at 1222, 23 Cal. Rptr. 2d at 247 (quoting *Love* v. *Fire Ins. Exchange*, 221 Cal. App. 3d 1136, 1153, 271 Cal. Rptr. 246, 256 (1990)).

2. We explained in the petition that, if this Court were not inclined to grant review to resolve the conflict over whether a federal diversity court may make new state law, it should at the very least grant the petition, vacate the judgment, and remand to the court of appeals for further consideration in light of *Waller*. *See* Pet. 22-25. We explained that under *Vandenbark* v. *Owens-Illinois Glass Co.*, 311 U.S. 538 (1941), the Ninth Circuit was obligated to conform its decision to this intervening decision of the California Supreme Court, and that this duty persisted "until such time as [the federal] case is no longer *sub judice*." *Id.* at 543. We also explained that when a lower federal court refuses even to consider the intervening state court decision, this Court will grant, vacate, and remand, to ensure that the court of appeals discharges its duty under *Vandenbark*. *See, e.g., Huddleston* v. *Dwyer*, 322 U.S. 232 (1944); *Exxon Co., U.S.A.* v. *Banque de Paris et des Pays-Bas*, 488 U.S. 920 (1988).

Developments since the petition for certiorari was filed have confirmed and heightened the need for action by this Court. In light of the California Supreme Court's decision in *Waller*, we filed with the Ninth Circuit on September 20, 1995, a Motion for Leave to File Untimely Petition for Rehearing; Petition for Rehearing and Suggestion for Rehearing En Banc. This filing followed the procedure sanctioned in *Braniff Airways, Inc.* v. *Curtiss-Wright Corp.*, 424 F.2d 427 (2d Cir.), *cert. denied*, 400 U.S. 829 (1970), and was intended to afford the Ninth Circuit the opportunity to act and consider the significance of *Waller* without the need for intervention by this Court. *See* Opp. App. 6a-9a.

On October 6, 1995, however, the Ninth Circuit denied National Union's motion for leave to file the petition for rehearing. Opp. App. 1a. In doing so, the Ninth Circuit has placed this case squarely on all fours with the facts in *Huddleston* and *Exxon*. In *Huddleston*, *Exxon*, and here, a federal court of appeals in a diversity case entered judgment against the petitioner based on an interpretation of

state law. In each case, a timely petition for rehearing was denied. In each case, the pertinent state court then issued a decision casting doubt on the federal court's construction of state law. In each case, the petitioner then reapplied to the court of appeals, seeking leave to bring the new state court decision to the attention of the court. In each case, leave was denied. In *Huddleston* and *Exxon*, this Court then granted a petition for certiorari, vacated the judgment below, and remanded for reconsideration in light of the intervening state court decision. It should follow the same course here.

AMI has no answer to the controlling significance of this Court's decisions in *Huddleston* and *Exxon*. Indeed, AMI does not even *cite* the cases in its opposition, much less attempt to distinguish them. AMI argues that this Court should deny certiorari because the Ninth Circuit denied National Union's motion for leave to file a petition for rehearing seeking to bring the *Waller* decision to that court's attention. *See* Opp. 15. As *Huddleston* and *Exxon* make clear, however, it is just such a refusal by a court of appeals even to reconsider its judgment that compels this Court to grant certiorari and remand to ensure that the court of appeals adheres to the clear dictates of *Vandenbark*.[4]

Rather than attempting to respond to *Huddleston* and *Exxon*, AMI elects to devote its opposition to arguing that the decision below and the California Supreme Court's opinion in *Waller* can be reconciled. AMI is wrong. AMI's action was for breach of the implied covenant of good faith and fair dealing, and the panel below held that under California law such an action could be maintained even if no policy benefits were due,

[4] AMI is quite wrong to contend that the Ninth Circuit's action on National Union's motion for leave to file a second petition for rehearing somehow obviates the need for action by this Court. The Ninth Circuit has not considered and denied National Union's second petition for rehearing; it has denied National Union leave even to file that petition. *See* Opp. App. 1a.

i.e., even if National Union had a valid coverage defense. As the panel put it, "[e]ven assuming * * * that [National Union] had a valid coverage defense, [National Union] would not be excused * * * from liability for the breach of its duty not to benefit at the expense of its insured. Thus the validity of [National Union's] coverage defenses is not controlling." Pet. App. 7a.

In *Waller*, the California Supreme Court addressed the identical issue, and ruled that the implied duty was triggered "when benefits are due an insured," but that absent "the insured's right to receive the benefits of the contract * * * the implied covenant has nothing upon which to act as a supplement, and 'should not be endowed with an existence independent of its contractual underpinnings.'" 44 Cal. Rptr. 2d at 390 (quoting *Love* v. *Fire Ins. Exchange*, 221 Cal. App. 3d at 1153, 271 Cal. Rptr. at 256). The remedy for "unfair practices that are independent of the insurance contract" is not a cause of action of the sort fashioned by the Ninth Circuit, but instead "administrative sanctions" imposed by the Insurance Commissioner. 44 Cal. Rptr. 2d at 390.[5]

In any event, AMI asks the wrong question in focusing on the merits. In *Huddleston*, this Court vacated and remanded because "[t]he second opinion of the Oklahoma Supreme Court * * * has at least raised such doubt as to the applicable Oklahoma law as to require its reexamination in the light of that opinion * * * before pronouncement of a final judgment in the case by the federal courts." 322 U.S. at 236-237. As the Court explained, "[t]hat doubt is not to be resolved in the first instance by this Court," but instead by the lower federal

[5] AMI contends this case is distinguishable from *Waller* because here there was coverage and the jury found National Union breached its insurance contract. The trouble with this argument, of course, is that the panel below repeatedly refused to address National Union's coverage arguments, holding instead that they were irrelevant to the existence of bad faith liability. *See* Pet. App. 6a n.4, 7a, 8a, 10a.

courts on remand. *Id.* at 237-238. There can be no serious dispute that the California Supreme Court's decision in *Waller* has at the very least cast doubt on the Ninth Circuit's decision to create a new state law tort remedy in this case. Under *Vandenbark* and *Huddleston*, that doubt requires the Ninth Circuit to reconsider its judgment. The Ninth Circuit's refusal even to entertain a petition for rehearing—the same action that prompted this Court's decisions in *Huddleston* and *Exxon*—should lead to the same result here as in those cases.

3. The Ninth Circuit's refusal even to permit the filing of a second petition for rehearing also places the Ninth Circuit in direct conflict with the Second Circuit's decision in *Braniff*. *Braniff* involved a diversity action that turned on Florida law. Following entry of judgment in the Second Circuit and denial of rehearing, the Florida Supreme Court issued a decision casting doubt upon the court of appeals decision. Even though a petition for certiorari seeking review of the Second Circuit decision was pending, plaintiffs—when they learned of the Florida court decision—filed a request in the court of appeals for " 'modification of decision of the court or for enlargement of the time to petition for rehearing.' " *Braniff*, 424 F.2d at 429 (quoting motion). After this Court denied certiorari, the Second Circuit considered whether it should entertain the second request for rehearing based on the intervening Florida decision:

> *Huddleston* seems to indicate that we should. Instead of reversing the court of appeals, and deciding the state law issues itself, the Supreme Court there vacated the court of appeals decision, and remanded to that court to permit it to determine the issues of state law in the first instance, on the basis of the new state court decision. For us to refuse to consider petitions for rehearing under the circumstances present here merely because a petition for certiorari has been filed would be, it seems to us, wasteful, for under the *Huddleston* procedure the Supreme Court would not reach the merits of the controversy, but

> would vacate our decision and order us to reconsider on the basis of the recent state opinion. [424 F.2d at 429-430.]

Several years ago this Court granted certiorari when the Fifth Circuit, like the Ninth Circuit here, placed itself in conflict with *Braniff* by turning aside a filing seeking to raise an intervening state court decision casting doubt on the Fifth Circuit's decision. *Exxon Co., U.S.A.* v. *Banque de Paris et des Pays-Bas*, 485 U.S. 1020 (1988). *See* Pet. for Cert., No. 87-1467 (filed March 4, 1988).[6] In that case this Court eventually followed its prior decision in *Huddleston* and remanded the case to the Fifth Circuit with instructions to do what it had refused to do and what the Ninth Circuit has now refused to do here—reconsider its decision in light of the intervening state court decision. *See* 488 U.S. 920. The Court's grant of certiorari in *Exxon* confirms the importance of the issue, and its disposition reaffirms the continuing validity of *Huddleston.*

4. The questions presented go to the heart of the proper role of federal courts exercising diversity jurisdiction and raise basic federalism concerns. Here the Ninth Circuit—expressly committed to an activist approach to creating new state law under *Erie*—created a new cause of action under California law. While the case was still *sub judice*, the California Supreme Court rejected that cause of action. Rather than conform its judgment to this decision, the federal court refused even to permit the filing of a second petition for rehearing designed to call its attention to that state court ruling. The Ninth Circuit has

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[6] The "Question Presented" in *Exxon* was:

> If after a federal court of appeals has entered judgment in a diversity case, but while the case remains *sub judice*, a state intermediate appellate court decides the controlling issue of state law in a manner that conflicts with the judgment of the federal court, should the federal court vacate its judgment and reconsider in order to ensure adherence to applicable state law? [Pet. for Cert., No. 87-1467, at i.]

lost sight of its limited role in construing state law in diversity, and this Court should grant the petition to reaffirm and clarify that role.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted. In the alternative, the petition should be granted, the judgment vacated, and the case remanded for further consideration in light of the California Supreme Court's decision in *Waller* v. *Truck Insurance Exchange*.

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